Ahmet Jakupi
FINANCIAL SOLUTIONS

22 November 2014

It has been a good year to be an American and a Canadian bond investor. Next year could be quite different. Ten-year notes in Canada currently yield just over 2%, while the 10-year Treasury yields about 2.36%, not far off the record lows seen in 2012 during the height of the European sovereign debt crisis. Yields remain low at a time when the American economy is especially surging, with strong growth in labor and housing. The economies of the America and Canada suggest that bond yields can't remain at current levels for much longer.

Fixed income investors have not given much weight to labor markets. In Canada, higher than normal involuntary part-time workers are the equivalent of a few extra tenths in the jobless rate, but the official measure of 6.5% has closed in on our 6.2% estimate of full employment.

America has passed the 6.5% rate the Federal Reserve once used as a criterion for rate hikes. Interest rate hikes are due to occur. The latest data show America's unemployment rate sits at 5.9%. Bond yields remain low because of investor fears about conditions outside America and Canada. The Eurozone and Japan are both either in recession or on the cusp of it, and the stability of China's financial sector and its shrinking economic growth continue to unnerve markets. The sheer strength of the Canadian and American labor markets will be enough to offset those concerns. In both countries, new jobs mean more families with room to spend, even if wage rates aren't yet firming up. The flight to safety propping up bonds will likely begin evaporating. Even a small dose of interest rate hikes will be a rude awakening. Unemployment rates fell in 34 states in October; a sign that steady hiring this year has been broadly dispersed through most of the country.

The America's Labor Department says unemployment rates rose in just 5 states, the fewest since April. Rates were unchanged in 11 states. Nationwide, employers added 214,000 jobs in October, the ninth straight month of gains above 200,000. That's the longest such stretch since 1995. The American unemployment rate fell to 5.8 percent, a six-year low, from 5.9 percent. Steady economic growth has prompted more companies to add jobs, though the additional hiring hasn't yet boosted wages. Georgia had the highest unemployment rate, at 7.7 percent, though that was down from 7.9 percent in September. North Dakota continued to have the lowest rate, at 2.8 percent.

The President of the ECB, Mario Draghi, strengthened his stimulus pledge for the euro area by saying the European Central Bank can't hold back in its fight to revive the economy. "We will do what we must to raise inflation and inflation expectations as fast as possible, as our price-stability mandate requires." Some inflation expectations "have been declining to levels that I would deem excessively low," he said. With the next policy meeting less than two weeks away and the region remaining close to economic stagnation, Mario Draghi may need to step up efforts to convince investors he's serious about reigniting growth and inflation. The Euro fell and bond yields dropped on speculation the ECB is closer to buying government debt in a full-scale quantitative-easing program. Mario Draghi is sending a clear signal that more stimuli are coming. The Euro was down 0.9 percent at $1.2428. The Stoxx Europe 600 Index climbed 2 percent. The yield on Spanish 10-year government debt fell 7 basis points to 2.03 percent, approaching the record low reached last month.

The ECB is trying to boost the size of its balance sheet to early-2012 levels, signaling an increase of as much as 1 trillion Euros ($1.24 trillion), to help revive the euro-area economy. Gross domestic product expanded just 0.2 percent last quarter and inflation is running at 0.4 percent, well below the ECB's goal of just under 2 percent. Any new action would follow a flurry of activity, since last June in interest-rate cuts, long-term bank loans, and covered-bond purchases.

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The ECB started buying asset-backed securities (ABS) today as it acquired notes backed by Dutch home loans, according to three people familiar with the matter, asking not to be identified because they're not authorized to speak about it. A spokesman for the ECB confirmed it started buying ABS, while declining to comment on specific purchases. Mario Draghi has declined to rule out large-scale government-bond buying and reiterated today that ECB staff is studying further measures to boost the economy if needed. Expanded measures may not win unanimous approval in the ECB's Governing Council. Governing Council member Klaas Knot said this week that he's "skeptical" about QE. Bundesbank President Jens Weidmann has argued that large-scale sovereign-debt purchases muddy the line between fiscal and monetary policy.

In the oil and energy sector, Saudi Arabia made a bold move this week, to specifically cut the price of oil sold to America and not to other oil consuming nations as an attempt to retain market share. The price of New York crude dropped but not the price of Brent crude. Europe and the rest of the world are paying much more expensive oil. Canadian oil producers are well positioned as low cost extractors and service providers of oil. However new producers of energy in America will be hurt. As an additional development, BP oil has decided to ignore the restrictions on the sale of oil outside of North America as imposed by Congress.

China cut interest rates unexpectedly today, stepping up efforts to support the world's second-biggest economy as it heads towards its slowest expansion in nearly a quarter of a century, saddled under a mountain of debt. China's Central Bank, keen to show it was not back-tracking on economic reforms, masked the interest rate cut as liberalization of the rates banks pay to borrowers in a bid to ensure millions of savers do not see their incomes hit. China's first rate cut in more than two years comes as manufacturing output growth stalls and the property market, once a pillar of growth, is weak, dragging down broader activity and curbing demand for everything from furniture to cement and steel. Many companies have also been struggling with debt, as slowing sales crimp their ability to pay back loans racked up in a nationwide frenzy of borrowing from 2008 - 2010 when Polit bureau leaders used economic stimulus to offset the effects of the global financial crisis. The People's Bank of China (PBOC) said it was cutting one-year benchmark lending rates by 40 basis points to 5.6 percent. It lowered one-year benchmark deposit rates by 25 basis points to 2.75 percent. The changes take effect from Saturday. Growth-sensitive commodities all leapt as China's move to cut rates gave markets a welcome lift after a week were data has shown its giant economy faltering.

While the cut in interest rates acknowledged the risks to growth and marks a stepped-up effort to ensure the economy stays on track even as it is expected to slow to a 24-year low of 7.4 percent this year, China Central Bank took pains to signal that it was not simply moving towards a looser monetary stance. Analysts expressed doubts over whether the impact of the rate cut would find its way into the real economy. As the economy cools, it makes lenders more risk-averse. Further interest rate cuts would be needed well into next year. Hurt by the cooling property sector, unreliable export demand and slackening domestic investment growth, China's economy is seen posting its weakest annual growth in 24 years this year at 7.4 percent. China's interest rate move comes after the Bank of Japan sprang a surprise on Oct. 31 by dramatically increasing the pace of its money creation, while European Central Bank President Mario Draghi shifted gear on Friday and threw the door wide open to quantitative easing in the euro zone.

In Canada, the consumer price index rose 2.4 percent year-on-year in October, putting inflation at the highest level since June and surpassing economists' forecasts for a more modest increase of 2.1 percent. The CPI rise in September was 2.0 percent. Unlike other central banks, the Bank of Canada is not cutting interest rates. Just on that basis, it warrants a higher Canadian dollar.

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Our Loonie, is outperforming nearly all major currencies against the American greenback, touched a high of C$1.1191 to the greenback, or 89.36 U.S. cents, more than a cent stronger than Thursday's close of C$1.1306, or 88.45 U.S. cents. At 9:26 a.m., the Canadian dollar was trading at C$1.1234, or 89.02 U.S. cents. Canadian government bond prices were mostly lower across the maturity curve, with the two-year shedding 5 Canadian cents to yield 1.068 percent, and the benchmark 10-year off 9 Canadian cents to yield 2.029 percent.

Canada's annual inflation rate jumped to 2.4 percent in October, pushed up by higher prices for shelter and food, and potentially putting pressure on the Bank of Canada's stance that interest rates will remain low for some time, Statistics Canada data showed on Friday. Inflation hit its highest level since June and surpassed expectations for a slight rise to 2.1 percent from September's 2.0 percent. Core inflation rate, closely watched by the Bank of Canada and strips out volatile items, rose to 2.3 percent and topped forecasts for 2.1 percent. The cost of shelter rose 2.8 percent in the 12 months to October, with natural gas prices rising by 20.1 percent. Food prices also rose 2.8 percent. On a monthly basis, consumer prices edged up 0.1 percent and core prices rose 0.3 percent. While the figures could put additional scrutiny on the Bank of Canada's cautious tone, the report on its own was unlikely to shift the central bank's monetary policy as policymakers have said that recent strength in prices is likely to be temporary.

Rumors of the great Canadian housing bubble are greatly exaggerated, says Greg Klump, chief economist for the Canadian Real Estate Association (CREA).While Canadian housing prices have increased an average 6.9 per cent so far this year (the highest in a decade), the more accurate housing price index (HPI) has increased 5.2 per cent for the first 10 months of 2014, which is the best in three years, according to CREA. Moreover, if you take Toronto, Vancouver and, to a lesser extent, Calgary out of the picture, the average price increase would be several percentage points lower, while other market measures, like sales-to-listings ratios and month's supply of homes for sale, are close to their 10-year averages. The problem with housing market bubble stories is that they fail to recognize fundamental housing market dynamics. For a big price correction to take place, a big and lasting run up in supply or a big and lasting drop in demand, or some combination of the two must occur. Since neither a recession (which would result in massive layoffs) nor a big spike in interest rates (which would drive up debt servicing costs) is on the horizon, a correction is not coming soon.

The average house price growth is being stretched by increasing average prices in two of Canada's most active markets, Vancouver and Toronto. What is going on in Vancouver and Toronto reflects a couple of things. One, you've got some very high-priced homes making up a greater proportion of the sales, pulling up the average price in those markets and for Canada, as a whole. For instance, Toronto saw a 9.0 per cent year-over-year increase in average home prices in October, versus the 5.5 per cent increase in HPI nationally. In addition, those price increases are largely in the central Toronto area, were densification initiatives (i.e., condo construction) have driven up the price of single-detached homes. "It's a function of the market since there is not enough supply to catch up with the demand. In Vancouver, you're capped by geography. There is no place to go. So there's a lot of expensive homes being sold and an ongoing shortage of affordable homes."

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