In the Spotlight

2020 Visions: Top Five Questions

- **Will there be a recession in 2020?** Our baseline assumption is that the economic damage triggered by the trade war will continue spreading to the broader economy (cap ex, inventories, international trade, and real estate) and result in a mild technical downturn defined by as little as two consecutive quarters of negative real GDP growth; certainly nothing as dramatic as the financial crisis.
- **What is the next move for the Fed?** The next move will be a cut; it is just a matter of time. Further accommodation will be needed to achieve inflation consistently near 2%. Over the past decade, monetary policy has imparted a negative bias to growth and inflation due to proximity to the zero bound. Basically, the Fed's reaction function has not been symmetric. They have been able to raise rates when the economy strengthened, but have limited room to cushion weakness. This implies that extra stimulus is needed to spur growth and inflation, pushing the economy away from the lower bound.
- **How will the excess collateral problem play out?** While the Fed's repo operations and balance sheet expansion have been effective to a degree, more aggressive action is needed to address the root cause of volatility in money markets.
- **Will the Fed follow the ECB into negative rates?** Negative rates are unlikely in the U.S. during 2020. First, a variety of Committee members including Chair Powell have given a definitive "no" answer to this question. Second, the Fed still has policy space to offer accommodation in addition to quantitative easing.
- **Will the U.S. political situation roil markets?** The Presidential election is likely to go down to the wire similar to 2016 and should be a highly traded theme as the election nears. By Super Tuesday on March 3, we will likely know the Democratic candidate—or at least the two finalists. This will usher in the stage when economic policy initiatives and changes to the federal government's regulatory stance will come into play.

Margaret Kerins, CFA
MD, Head of FI Strategy
+1 (312) 845-2687
margaret.kerins@bmo.com

Ian Lyngen, CFA
MD, Head of US Rates Strategy
+1 (212) 702-1703
ian.lyngen@bmo.com

Greg Anderson, CFA, PhD
Director, Global Head of FX Strategy
+1 (212) 605-1409
gregory.anderson@bmo.com

Stephen Gallo
European Head of FX Strategy
+44-2076648124
stephen.gallo@bmo.com

Daniel Krieter, CFA
Director, FI Strategy
+1 (312) 845-4015
dan.krieter@bmo.com

Benjamin Reitzes
Director, Cdn Rates & Macro Strategist
+1 (416) 359-5628
benjamin.reitzes@bmo.com

Daniel Belton, PhD
VP, FI Strategy
+1 (312) 845-5068
daniel.belton@bmo.com

Jon Hill, CFA
VP, Rates Strategy
+1 (212) 702-1270
jonathan.hill@bmo.com

Benjamin Jeffery
Analyst, Rates Strategy
+1 (212) 885-4135
benjamin.jeffery@bmo.com

Will There be a Recession in 2020?

In the year ahead, the operative debate will be whether or not the Fed's 75 bp of fine-tuning rate cuts were 'preemptive enough' to avoid a domestic recession. Our baseline assumption is that the economic damage triggered by the trade war will continue spreading to the broader economy (cap ex, inventories, international trade, and real estate) and result in a mild technical downturn defined by as little as two consecutive quarters of negative real GDP growth, certainly nothing as dramatic as the financial crisis. In fact, such a contraction could go effectively

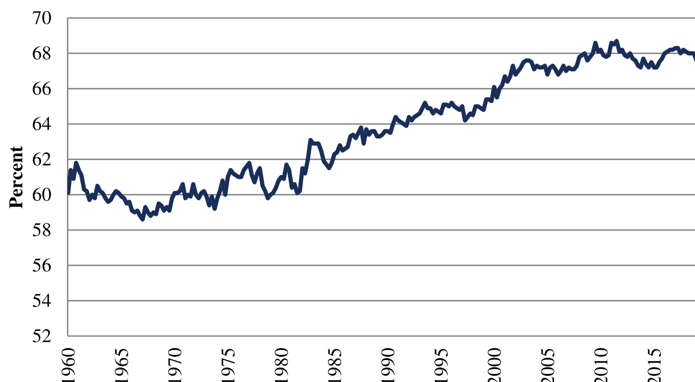
'unnoticed' at the time and only in revisionary hindsight will the NBER call it a 'recession'. For context, during the last five recessions, the lag between the commencement of the event and the NBER's acknowledgment thereof ranged between 5 and 14 months; with an average of 7.6 months. Said differently, the slowing momentum and global headwinds might stall growth in 2020 so subtly as to not be evident until the following year. As the Fed's GDP trackers are currently projecting <0.5% Q4 growth, this narrative is easy to embrace.

Let's face it, growth in the US is driven primarily by the consumer and conventional logic holds that any significant recession owes its origins to a reluctance to spend. The correlation between a confident consumer and elevated spending is high, so we're watching for the recent drop in the optimism data to further curtail retail sales and ultimately the contribution of PCE (both services and goods) to real GDP (Figure 1). This is where the nuance of the mild versus major recession comes into play. We don't need to see the services sector slip into negative territory for goods spending, business investment, international trade and the housing market to drag aggregate growth to the zero bound and beyond. This has arguably already begun as the most recent two consecutive quarters have seen negative contributions to the quarterly real GDP moves from capex, inventories, and international trade; to say nothing of the fact fixed private residential investment during six of the last seven quarters has been a net drag on growth – so much for the effectiveness of monetary policy spurring the wealth effect through the housing market.

We'll be the first to acknowledge that the 'art' is timing the inflection point at which falling confidence (business and consumer) finally translates into fewer jobs and a dwindling propensity to spend. This dynamic has yet to occur in earnest, although when it does the transition tends to be swift and sharp.

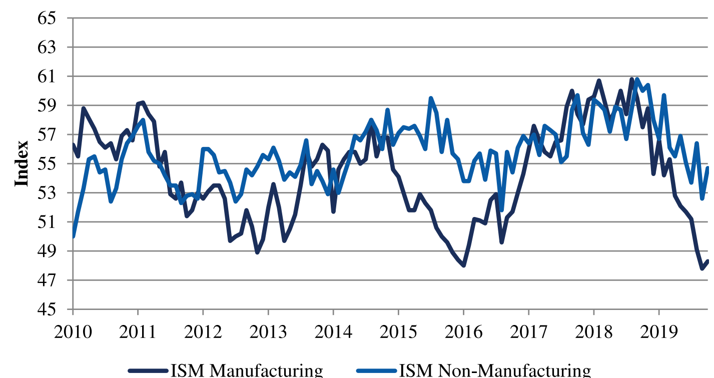
Moreover, we're primarily concerned about the performance of the domestic economy, after all, 10s wouldn't be sub-2.0% if global prospects hadn't already dimmed; think Europe, China, Brexit – the list goes on. Trade tensions have hit the global manufacturing sector hard. On the one hand, there has been limited spillover into the US service sectors and tentative signs of stabilization are emerging (Figure 2). On the flip side, debt dynamics in many developing and emerging economies are weak or weakening. Global debt-to-GDP is higher now than at any point just prior to the financial crisis, and most of the run-up in debt has been EM-driven (Figure 3). In addition, progress towards growth-unleashing structural reforms in many economies has been limited at best. This will keep global yields well anchored, preventing any meaningful depreciation of the USD and offset the risk the Fed faces an imported inflationary impulse.

Figure 1 - Personal Consumption Expenditure as % of GDP



Source: BMO CM, BEA

Figure 2 - ISM Manufacturing vs ISM Non-Manufacturing



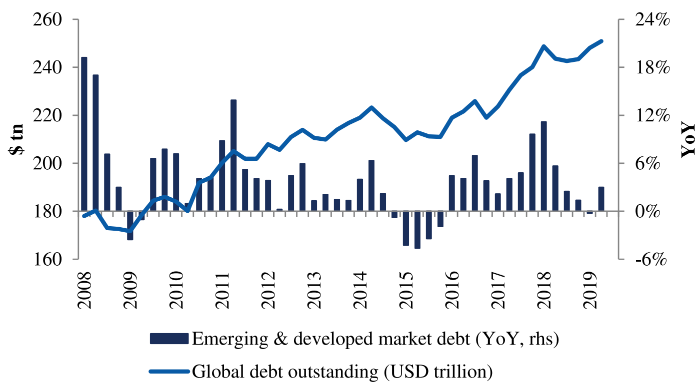
Source: BMO CM, Bloomberg

What is the Next Move for the Fed?

The reaction function of the Fed will be based on the performance of the domestic economy and any progress (or lack thereof) on the trade war; this is a departure from the preemptive narrative which dominated monetary policy throughout 2019. In an endeavor to rekindle inflation back to and through their 2% target, a prolonged period of the Fed on hold is the path of least resistance as numerous Committee members have expressed comfort with the current, slightly accommodative, stance of policy (Figure 4).

However, the next move will be a cut; it is just a matter of time. Powell is actively trying to recast the way in which the market views the Fed's relationship with inflation. While the FOMC has a long and successful track record of battling pricing pressures from accelerating beyond the control of policymakers, their reputation in combatting deflation is less stellar. For this reason alone, the bar will be comparatively high to increase rates (i.e. PCE will need to be well above target for a longer period than in prior episodes to trigger a Fed response), whereas there are a variety of scenarios in which further accommodation is easy to envision.

Figure 3 - Global Debt Outstanding and Annual Growth Rate



Source: BMO CM, IIF

Figure 4 - Core-PCE YoY

Source: BMO CM, Bloomberg

How Will the Excess Collateral Issue Play Out?

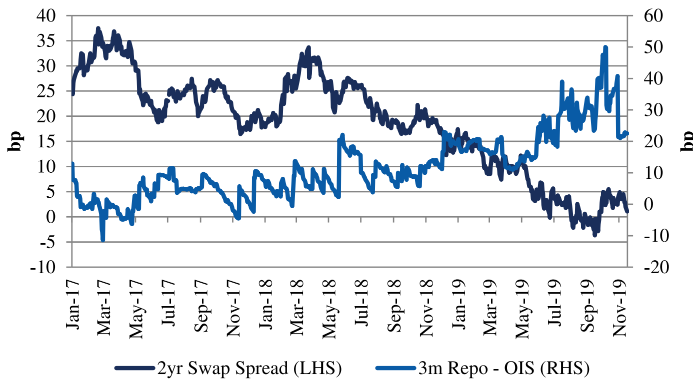
Our base case is that the Fed will continue to address the excess collateral issue by growing reserves and conducting daily repo operations, and will look to expand the list of eligible counterparties for its repo operations to include non-primary dealers next year. Without an expanded counterparty list, primary dealers are unable to net repo done with the Fed, and the excess collateral problem is only partially solved due to balance sheet constraints. This is evidenced by continued elevated funding rates and narrow swap spreads (Figure 5). Barring an expansion of eligible repo counterparties, the situation should persist and potentially worsen given elevated Treasury supply through Q1 20. Should the Fed strengthen its current tools, however, the problem will be solved in the first half of next year. This should send 2yr and 54yr swap spreads wider by 5bp to 7bp.

The most direct and effective solution to the excess collateral issue would be the implementation of a standing repo facility (SRF) in conjunction with an announcement from the Fed that Treasuries would be treated the same as reserves from a liquidity regulation standpoint. The assurance that counterparties could convert cash into reserves would make banks more willing to hold Treasuries and relieve dealer inventories. However, the implementation of a SRF is no longer our base case. We view the chance of a standing repo facility in 1H 20 as about a 20-25%. In addition to concerns over lending to a broader list of counterparties than just primary dealers, a SRF could encourage increased

leverage in the financial system to the extent that it encourages increased repo activity, a consequence the Fed may prefer to avoid.

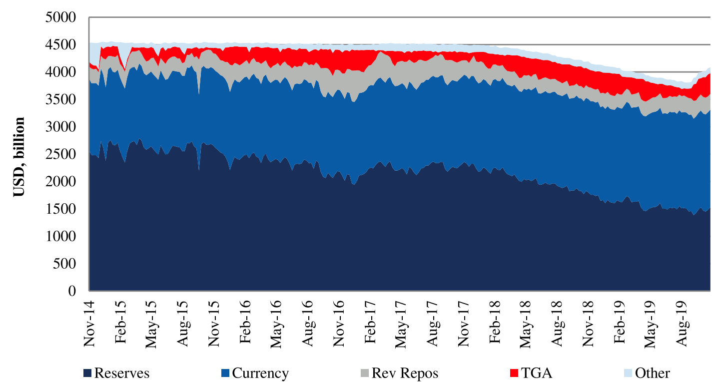
The Fed could also relax any of a number of regulatory requirements including the supplementary leverage ratio (SLR) or the GSIB surcharge. This has been discussed before but the Fed has passed on opportunities to relax these regulations. Even if the Fed opts to change one of these, it will be a slow moving process, unlikely to be completed by mid-2020.

Figure 5 - 2yr Swap Spreads versus Repo - OIS



Source: BMO CM, Bloomberg, Garban Intercapital

Figure 6 - Fed Balance Sheet Composition



Source: BMO CM, FRBNY

Will the Fed Follow the ECB into Negative Rates?

In a word… No. Given the definitive answers from a variety of Committee members including Chair Powell, negative rates are unlikely to become a reality in the US during 2020. This is not to say the possibility will not seriously be discussed during the next downturn. However, given the depth and complexity of the domestic money market, the issues associated with negative short rates will outweigh the stimulative benefits for the time being. Additionally supporting the case against negative rates being required is the fact that unlike the ECB or BoJ, the Fed still has policy space to offer accommodation in addition to the potential introduction of another true quantitative easing program.

Will the Political Situation Roil Markets?

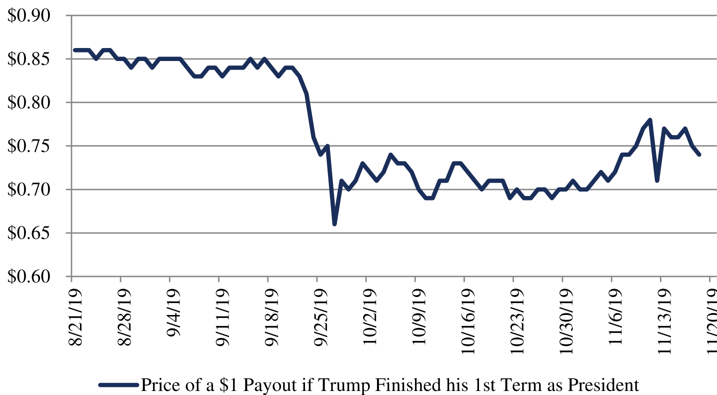
The ultimate question for 2020 is who will win the U.S. Presidential election on Nov 3. A related but secondary question is whether the leadership of either House or the Senate will be altered. Congressional control is likely to remain unaltered and untraded in markets, but the Presidential election will probably to go down to the wire similar to 2016. This means that the election should be a highly traded theme due to the divisive policy proposals. Even precursor events will attract amplified market interest.

The first precursor event of 2020 is likely to be the Trump impeachment trial in the Senate. The timeline for this is fluid (and very easily subject to extension), but we would put it in roughly weeks two to four of January. Currently, the trial seems unlikely to lead to Trump's removal, but there is always the risk that new information is revealed between then and now that could alter the roughly 50:50 outlook for the election.

The first Democratic Party primary is February 3 followed by Super Tuesday on March 3. At this point, we will likely know the Democratic candidate or at least the two finalists. This will usher in the stage where economic policy initiatives like MMT (modern monetary theory), wealth taxes, fracking bans and changes to the federal government's

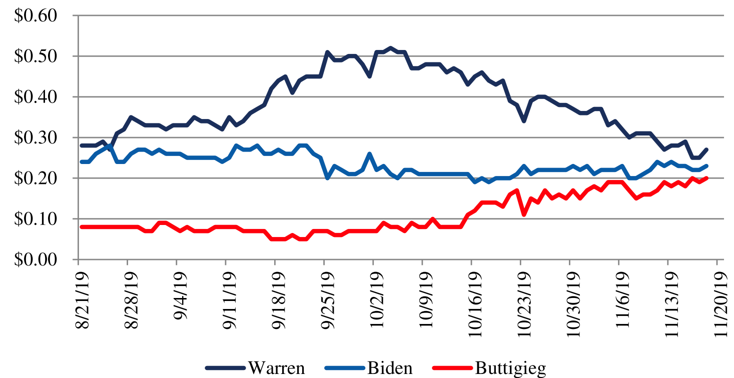
regulatory stance will come into play. These policy initiatives could have an outsized impact on specific industries (energy, healthcare) depending on who the candidate is and how they are polling. At the same time, the state of the economy is likely to be the dominant factor for U.S. rates and FX markets, but the election will add volatility.

Figure 7 - Political Future on "Will Trump Complete His First Term?"



Source: BMO CM, Predictit.com

Figure 8 - Political Future "Will Candidate Win the Democratic Party Nomination?"



Source: BMO CM, Predictit.com

2020 Outlook Overview

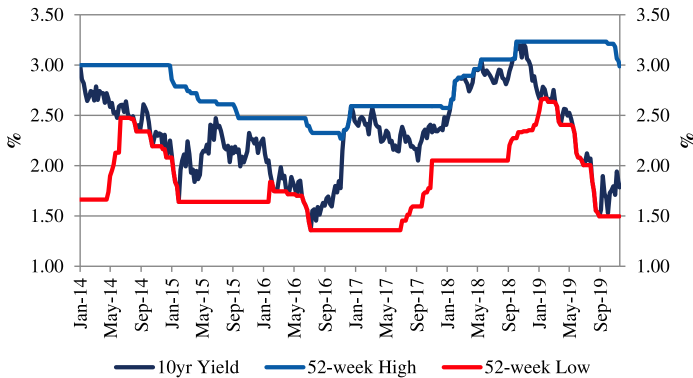
US Rates

The trade war damage to business investment and corporate sentiment will ultimately trigger a more marked slowing in economic activity. In terms of price action, we think the Fed's pivot back toward an easing bias sometime in H2 will mark a transition from a bear steepening to a bull steepening of the 2s/10s curve as the Committee and the market's focus quickly turns to the effective lower bound. In outright yield terms, the operative question will be to what extent the Fed's pause offers hopes of reflation and economic growth in setting the starting point from the eventual flight-to-quality and cut-driven rally. We are still of the mind 10-year yields can trade north of 2.0%, however any backup beyond 2.25% will likely prove too appealing for dip buyers to pass up.

In addition, we are solid in our conviction that the trading range of 100-125 bp in 10s will once again hold, based on ranges over the past several years (Figures 9 and 10). Therefore, the most relevant unknown for 2020 is if the center of that range is 2.00%, 1.75%, or 1.50% – we're erring on the side of lower. This implies:

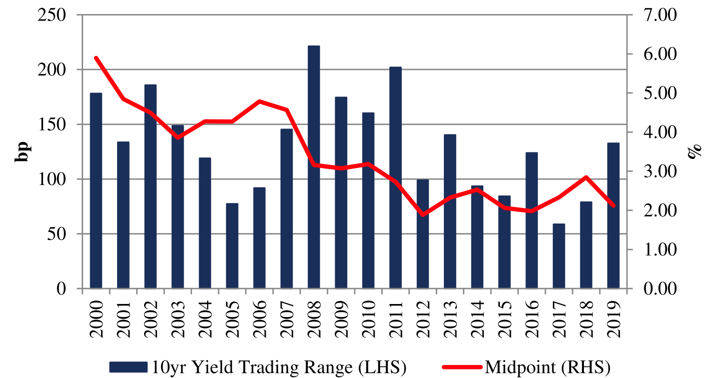
1. 10s testing the 2.00-2.25% range is very doable.
2. Record low 10-year yields in H2 2020 is also achievable without any challenge to the prevailing logic.
3. Next year is unlikely to be a 'trending' market – but instead the most prudent approach is anticipating episodes of both bullish and bearish extremes.

Figure 9 - 10-year Yields and 52-week Range



Source: BMO CM, Bloomberg

Figure 10 - 10yr Treasury Trading Range vs Midpoint

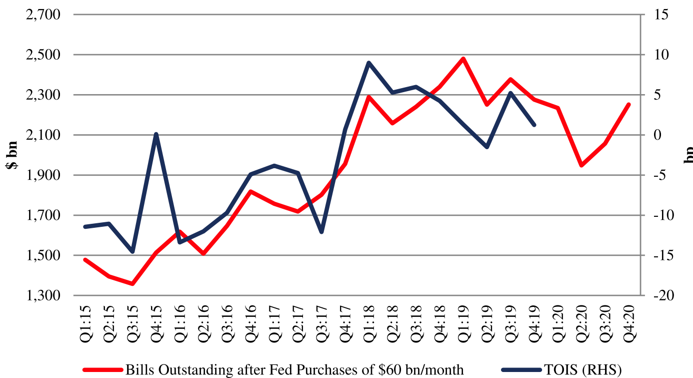


Source: BMO CM, Bloomberg

US Short Rates

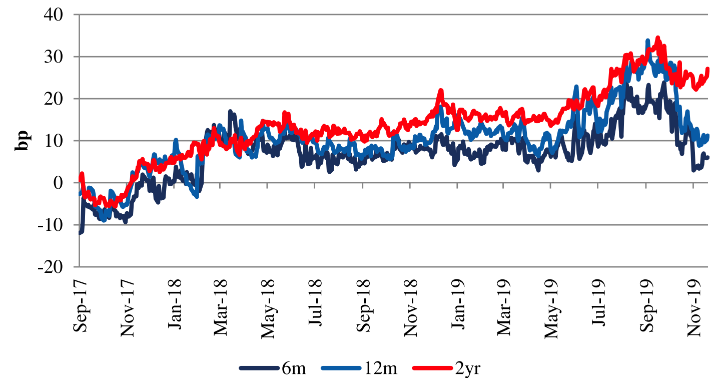
There are four key factors that will drive the front-end in 2020: the path of Fed policy, net Treasury issuance, how much the Fed increases cash in the system, and any regulatory adjustments. Even following substantial compression in a variety of front-end T-OIS spreads in Q4 2019, we still think there is further room for short-dated yields to fall and anticipate both the 6- and 12-month sectors to trade flat or slightly through OIS. In addition, portfolio rebalancing will impact short Treasury coupons out to the 2-year tenor and we expect 2-year T-OIS to compress to 15 bp in H1 2020.

Figure 11 - 3m Treasury OIS vs Bills Outstanding



Source: BMO CM, Treasury, Bloomberg

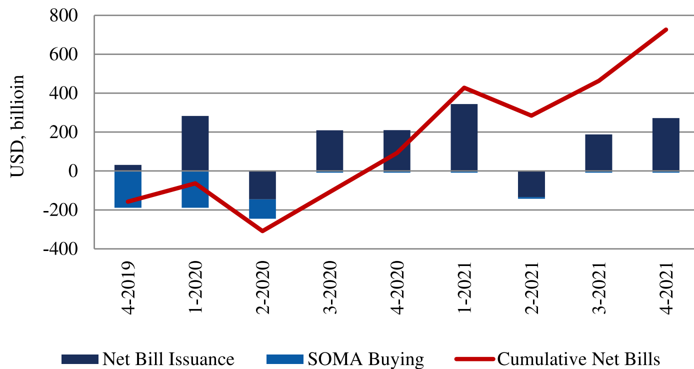
Figure 12 - 6m, 12m, and 2yr Treasury-OIS



Source: BMO CM, Bloomberg

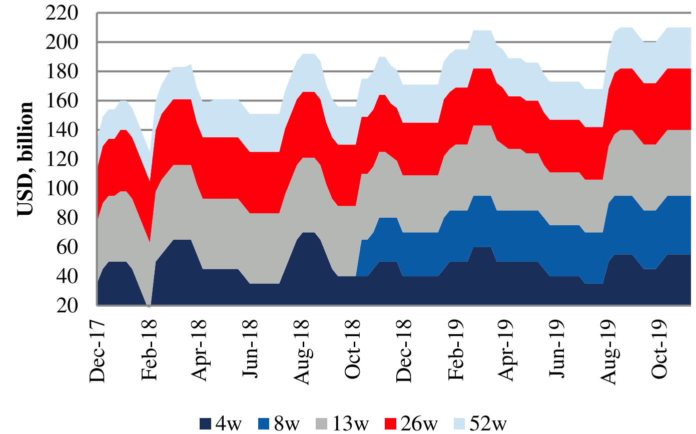
For bill supply, the seasonal contraction due to tax season will be exacerbated by the Fed's bill purchase program, currently set at $60 bn per month. While it's not obvious how long they will maintain this speed of buying, it's very unlikely that this scale of reserve growth will be warranted through Q2 of next year. How the Fed calibrates these operations will be a core input for the bill market and other correlated money markets. In general, a faster pace for longer will tighten spreads versus matched-maturity OIS more, and vice versa.

Figure 13 - Quarterly Net Treasury Bill Supply



Source: BMO CM, Bloomberg, FRBNY

Figure 14 - T-Bill Auction Sizes Already $200 bn per Week



Source: BMO CM, Bloomberg

A second factor on the issuance front is whether the US Treasury will begin issuing SOFR-linked debt. We expect a 1-year maturity SOFR floater to be eventually brought to market, with outstanding questions as to the size and timing of any rollout. Although Treasury is relatively well funded out until 2021, it's possible such a product could appear before then due to the positive externality of deepening the SOFR market and assisting in the transition away from LIBOR.

In terms of cash outstanding in the system, this will be a function of how aggressively the Fed rebuilds reserves and money market flows. After the extreme repo volatility in September 2019, we would assume the central bank errs on the side of more liquidity provision by ensuring sufficiently abundant reserves to avoid future dramatic bottlenecks. In addition, for over the past two years, there have been consistently strong inflows into money market funds, reflecting improved relative value (FOMC hikes) and a de-risking bias as global recession fears grew. If this trend pauses or partially reverses, that would contribute to front-end cheapening relative to the path of policy.

Finally, on the regulatory side, we don't anticipate any rollback of major post-crisis rules but instead will look for some recalibration of guidance around intraday buffer needs and the use of daylight overdrafts. While a bit in the weeds, the result of this would be to free up bank reserves for other purposes, including increased repo and short-Treasury coupon allocations. If this occurs, look for more muted upward pressure on secured funding rates as the increased elasticity of bank balance sheets would be more limber in responding to dislocations.

High Quality Spreads

The risks to swap spreads and credit spreads are skewed to wider. Current credit valuations are rich to fundamentals due to the extended reach for yield trading environment and two years of supportive technicals. Spreads to Treasuries across the credit curve are near YTD tights (Figure 15). In contrast, asset swap spreads are somewhat attractive and high quality debt should outperform swaps in the medium-term (Figure 16).

Several factors point to the end of the yield grab environment. First, cracks are appearing in the leveraged loan market including growing downgrades and substantial losses. Second, macroeconomic headwinds, while lower than a couple months ago, remain elevated. The Fed is now messaging a higher bar for further cuts, removing, albeit temporarily, one of main drivers of the spread market outperformance over the past six months.

Over the medium-term, swap spreads are set to widen when the Fed eventually solves the excess collateral problem, relieving upward pressure on repo rates. This will reverse the primary driver of narrow swap spreads. However, the

path to wider swap spreads will be choppy due to short-lived periods of pessimism surrounding funding, particularly as year-end approaches (Figure 17).

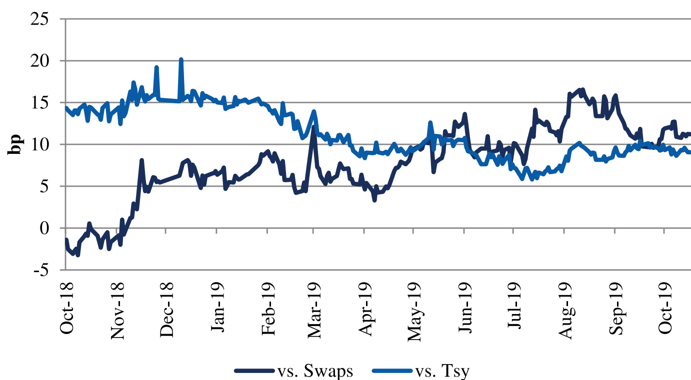
Figure 15 - YTD Spread Levels

	Gov't OAS				
	11/19/2019	YTD Change	YTD Tight	YTD Wide	YTD Avg.
US Agencies	6	-5	4	11	7
Washington Supra	8	-7	6	20	10
European Supra	8	-12	6	21	11
IG Corp	112	-47	111	163	126
AAA	58	-20	57	80	65
AA	58	-29	57	89	67
A	86	-38	84	128	97
BBB	145	-57	142	206	162

*Agency and Supra spreads in 5yr sector; corporate spreads from index data

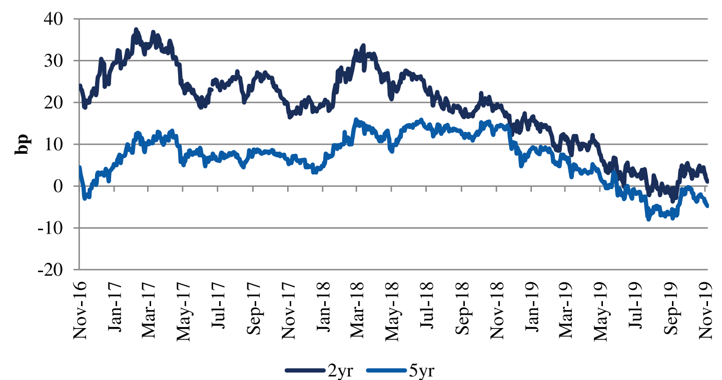
Source: BMO CM, TradeWeb, ICE BAML Indices

Figure 16 - 5yr Global Supra Spreads



Source: BMO CM, TradeWeb

Figure 17 - Swap Spreads

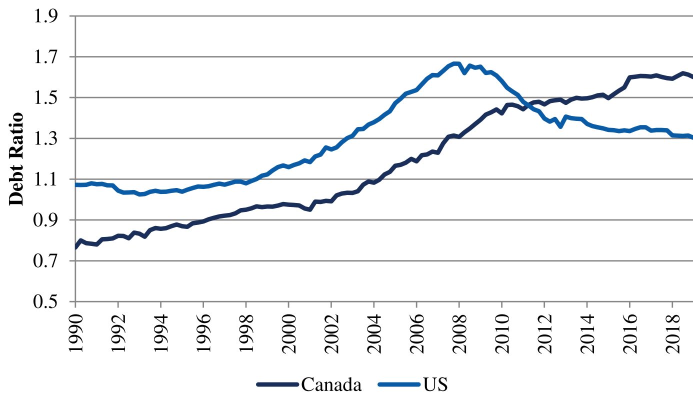


Source: BMO CM, Bloomberg

Canadian Rates

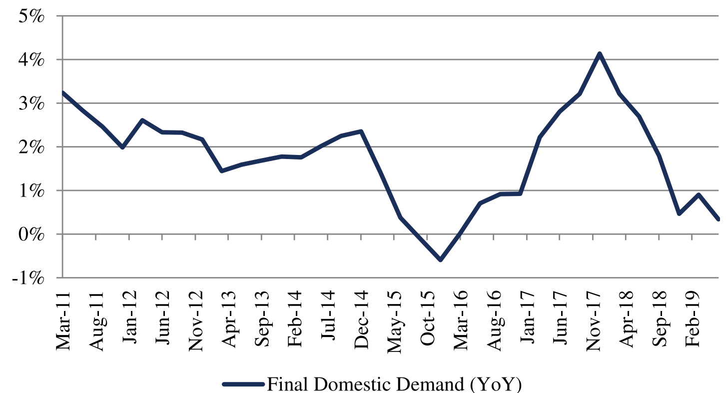
The story through much of 2019 was the Bank of Canada's unwillingness to follow the Fed in cutting policy rates. The BoC's dovish turn in October has ended that narrative and while our base case is for no moves in 2020, the risks are skewed to the downside. The late 2018 stress in the Canadian oil market drove growth dynamics that made it appear as though Canada was performing relatively well amid the trade war-driven global slowdown. While there's still Q4 data to come, the second half shows that Canada has been impacted by the global weakness as well. The bigger issue for the Canadian macro picture is the near-record household debt ratios and the resulting limit on consumption growth and housing (Figure 18). This is a long-run issue and will restrain growth for the foreseeable future. The debt burden has a two-fold impact on Bank of Canada policy. First, it limits the appetite of the BoC to ease as they don't want to push debt burdens higher still. However, there are limits to this line of thinking as 2015 rate cuts showed; the BoC will still cut if/when it becomes necessary. Second, due to high debt levels, the impact of any rate hike is much more pronounced, limiting how high interest rates can go. For now the BoC is boxed in on rates, but given the limited growth drivers for Canada, the risks are clearly skewed to the downside (Figure 16). Factors that could prompt a rate cut in 2020 include the C$, Fed cuts, disappointing growth, etc.

Figure 18 - Household Debt Capping Rates



Source: BMO CM, Statscan, Federal Reserve, BEA

Figure 19 - Canadian Economy Lacking Growth Drivers



Source: BMO CM, STCA - Statistics Canada

There is one potential upside for the economy that the BoC appears to be banking on: fiscal policy. The minority Liberal government is expected to unveil increased spending (we'll get more details from the Throne speech on December 5). Governor Poloz said that $5 bn of fiscal stimulus equates to a 25 bp rate cut. That's a clear sign the Bank would like to see fiscal policy take the burden off monetary policy for the time being. Even so, that doesn't change the fact that policy risks are skewed one way…to the downside.

With the BoC's dovish turn and the risk profile to the outlook, the front of the Canada curve should remain well supported (Figure 20). Indeed, any increase in Fed easing odds will likely be matched in Canada, with the potential for the BoC to cut solo as well. Accordingly, there's room for Canada to outperform in the front end. Further out the curve, Canadian rates will follow US Treasuries' lead, in turn dependent on the evolution of US-China trade tensions and global growth dynamics (among other factors).

We're bearish on rates in the near term, with 1.82% on Canada 10s seen as meaningful support, and look to at least test those levels. The near-term bearishness would be consistent with steepening in 2s/10s, as the front end remains supported by the BoC's dovishness. However, with policy rates only able to reach 1.75% at the peak of the cycle, there are limits to how high long-term rates can get. That in turn means the extent of potential curve steepening is relatively limited, though a move up to +30 bps in 2s/10s is certainly within reason. A return to the extreme inversion seems unlikely due to the BoC's dovish shift.

Figure 20 - Dovish BoC Supports Steepening

Source: BMO CM, Bloomberg

Foreign Exchange

Given the general fundamental picture, the prospects for sustained appreciation of the major European & Asian currencies vs. the USD currently look dim for H1 2020. We expect Brexit to be resolved by January 31 2020, but there are significant risks that it won't be. If it is, the focus in FX will immediately shift to what is likely to be a very difficult set of trade negotiations after the UK legally exits the EU; it's possible that the transition period will end without an FTA in place, and this will put a ceiling on top of EURUSD and GBPUSD. If Brexit remains unresolved, then the political uncertainty alone should be enough to deter investor interest in both the EUR and the GBP.

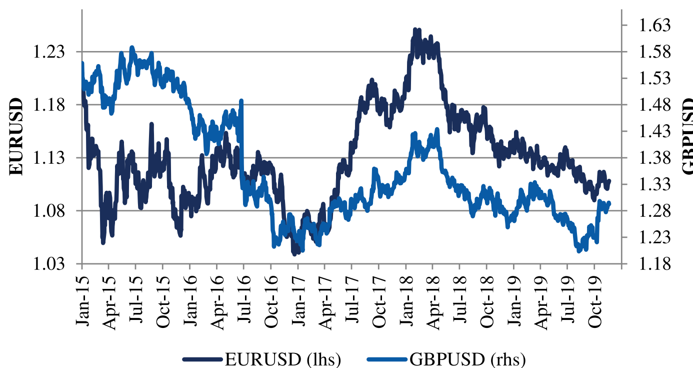
In the Eurozone, the completion of a European banking union, the fiscal policy stance and the EUR outlook are all intertwined. The keys to completing a banking union are an increase in risk sharing, more conditionality and a decline in sovereign risk. But all of these elements are partly dependent on faster economic growth, which could require an additional loosening of fiscal policy. It is unclear whether all Eurozone member countries will agree to take such a big leap in one direction simultaneously. Therefore, we currently foresee only slight upside risks to the EUR from looser fiscal policy next year.

The Japanese yen has been fairly dormant for the past couple of years and that is likely to remain the case. The BoJ has adapted a more overt easing bias, but probably the most realistic thing it can do is ramp up its QE program slightly by committing to buy ETFs at a bit more rapid pace. This influence, along with a sidelined Fed and moderately higher global energy prices should keep JPY from drifting stronger any faster than it has in 2019.

Assuming current levels roughly hold, CAD will be the best performing G10 currency of 2019. Most other G10 central banks eased in 2019 while the BoC held pat. Although the BoC is much more likely to behave in alignment with the 'herd' in 2020, we don't look for the herd to do much. That leaves CAD as the ongoing G10 highest yielder. It also retains 'twin deficit' dynamics that are much better than most G10 peers as it continues to evolve toward safe-haven status. With that in mind, we would look for ongoing mild CAD outperformance (barring a global recession).

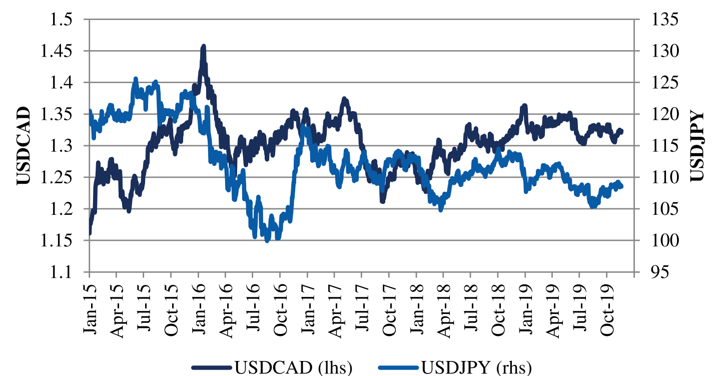
Recent data suggest China's economy hasn't bottomed yet. Even with a partial tariff rollback, it is hard to make a case for sustained RMB strength. China is in the midst of a deeper correction and reorganization of its financial system, so we expect at least some additional monetary easing over the coming months. Incremental increases in fiscal, infrastructure and investment spending will provide a layer of support for the RMB in H1 2020, but there are still few if any signs that policymakers will engage in aggressive stimulus.

Figure 21 - Spot EURUSD and Spot GBPUSD



Source: BMO CM, Bloomberg

Figure 22 - Spot USDCAD and Spot USDJPY



Source: BMO CM, Bloomberg

Contacts

Margaret Kerins, CFA
MD, Head of FI Strategy
margaret.kerins@bmo.com
312-845-2687

Ian Lyngen, CFA
MD, Head of US Rates Strategy
ian.lyngen@bmo.com
212-702-1703

Greg Anderson, CFA
Director, Head Global FX Strategy
gregory.anderson@bmo.com
212-605-1409

Stephen Gallo
Director, Head European FX Strategy
stephen.gallo@bmo.co
44-2076648124

Dan Krieter, CFA
Director, Fixed Income Strategy
dan.krieter@bmo.com
312-845-4015

Benjamin Reitzes
Director, Canadian Rates & Macro Strategist
benjamin.reitzes@bmo.com
416-359-5628

Dan Belton, PhD
Vice President, Fixed Income Strategy
daniel.belton@bmo.com
312-845-5068

Jon Hill, CFA
Vice President, Rates Strategy
jonathan.hill@bmo.com
212-702-1270

Ben Jeffery
Analyst, Rates Strategy
benjamin.jeffery@bmo.com
212-885-4135

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