Portfolio Management

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Fixed Income Strategy

Beware of the Volatility!

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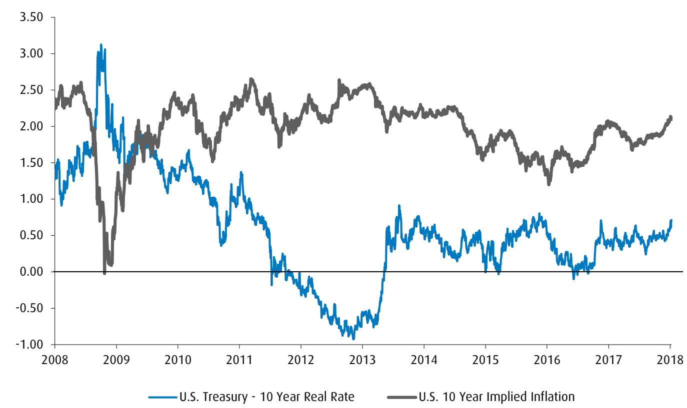
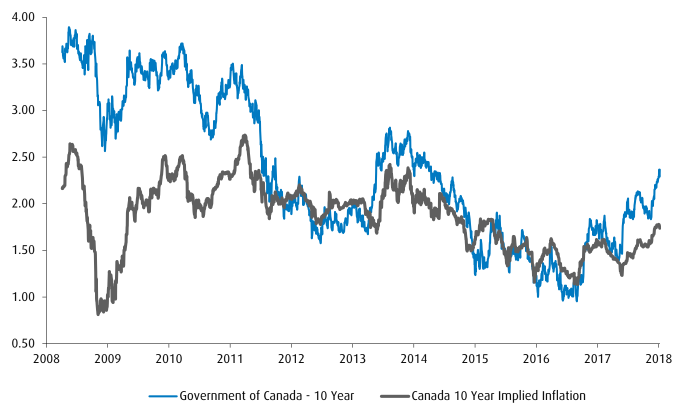
2018 was one of the weakest starts of the year that fixed income markets have seen in a while. Rising rates, a trend that resumed last November, accelerated into January, driving the weakness. Even a U.S. government shutdown and an equity market pullback in early February could not significantly alter the trend. Government of Canada (GoC) yields rose between 26 and 32 basis points (bps) in the 5 to 10 year sector and between 30 and 40 bps for U.S. treasuries of a similar term, pushing total returns into negative territory. This negative performance was driven not only by higher inflation expectations but also by higher real yields, a reflection of stronger economies and tighter monetary policies.

Figure 1: U.S. 10-Year Real Rates and Inflation Expectations



Source: Bloomberg

Figure 2: Canada 10-Year Real Rates and Inflation Expectations



Source: Bloomberg

From a technical perspective, the downtrend in long term interest rates appears to have reversed, reinforcing the belief that we are at the end of the 35+ year bond bull market (rising rates implies lower prices for bonds, and vice versa). We note that historically both bull and bear cycles have lasted between 35 and 40 years, but with central banks still very much involved with asset purchases and accommodative policies, it may still be a bit early to call for the beginning of a new cycle. We can appreciate all the attention this is gathering but, in our opinion, the economic, demographic and social environments have significantly changed, making direct historical comparisons more difficult. Experience tells us that we will get the official confirmation of a new cycle only after it has started.

Figure 3: Long Term Canada Yields

Source: Bank of Canada

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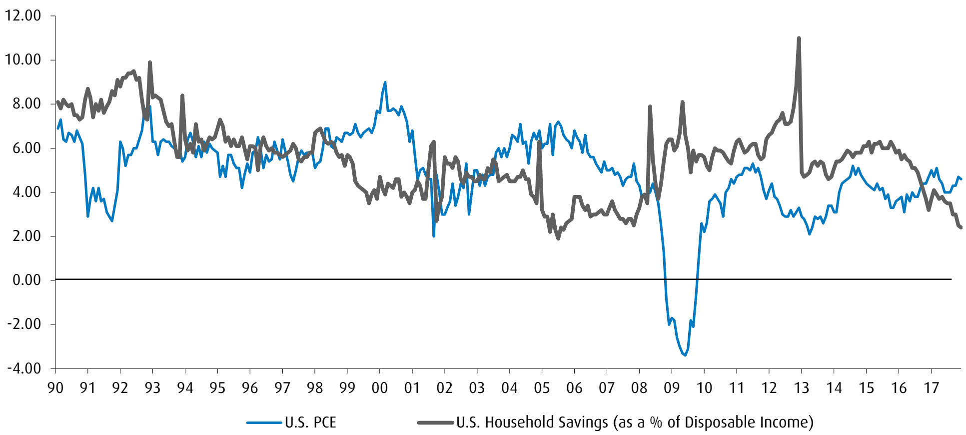
One thing we will not debate is the fact that strengthening global economies and labor markets are leading major central banks to gradually reduce monetary stimulus and pressure yields higher. In the U.S., we also need to consider the potential impact of government reforms (tax cuts, infrastructure spending) on interest rates in general. It is expected that the tax reform will likely result in higher budget deficits that could lead the U.S. treasury to increase the supply of bonds this year by an estimated USD 500 billion. If we combine the supply issue with the Fed starting to scale back its treasury purchases and China floating the idea (again!) that it could reduce exposure to the treasury market, you have a perfect recipe for a run-up in yields. Add to the mix the uncertainty that comes with a new and less experienced Federal Reserve Chair (Jerome Powell), and we better understand fixed income investors' concerns.

But is it enough to justify the most recent increases and significantly higher rates? Potentially yes, but for every factor in support of higher rates we find one against it. While the bias is for rising interest rates, we expect the process to be gradual over a longer term period. Global central banks have not indicated that they are about to accelerate the pace of policy tightening, and we still do not have inflationary pressures, as inflation remains below targets in many regions. In addition, gross domestic product growth in Canada and the U.S. is expected to decelerate in 2018 and 2019, as forecasted by BMO Economics. This would effectively limit the risk for overheating economies. Furthermore, the rise in interest rates will likely reduce households' financial flexibility and propensity to spend. Despite the tax cuts, the savings rate remains low, particularly in the U.S., where it is approaching its lowest level in over 30 years. Overall, from a fundamental perspective, not a lot has changed that would derail the current expectations for the *gradual* removal of monetary policy moving forward.

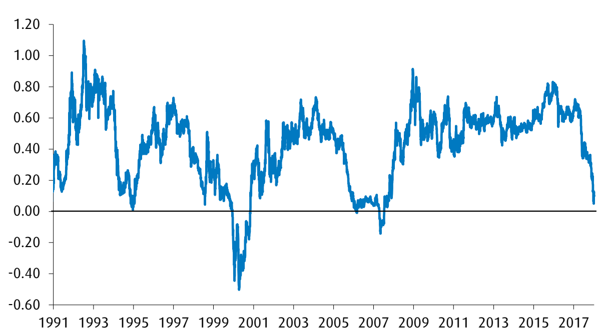
Figure 4: U.S. Personal Consumption Expenditures (PCE) versus Household Savings



Source: Bloomberg

However, a gradual tightening would not eliminate the prospect for higher volatility as not all potential risks seem to be properly priced in. The market is pricing in some of the risks that affect the short-end of the curve. Back in December, markets were only pricing in 30% odds that the Fed would follow through with its three rate hikes for 2018. We are currently at over 70% odds. As investors, however, we need to use caution as inflation and term risk does not seem to be priced into the long end of the yield curve. We suspect that any uptick to inflation, even without significant fundamental deterioration, could lead to further volatility. The situation may not be as critical in Canada, as the Bank of Canada has already delivered one hike in January. Despite the market pricing in almost two more hikes, Governor Stephen Poloz commented that the bank remains fully dependent on data and that rates may not go up again this year. This may slow the rise in Canada, but not necessarily eliminate the volatility risk at the long end of the yield curve.

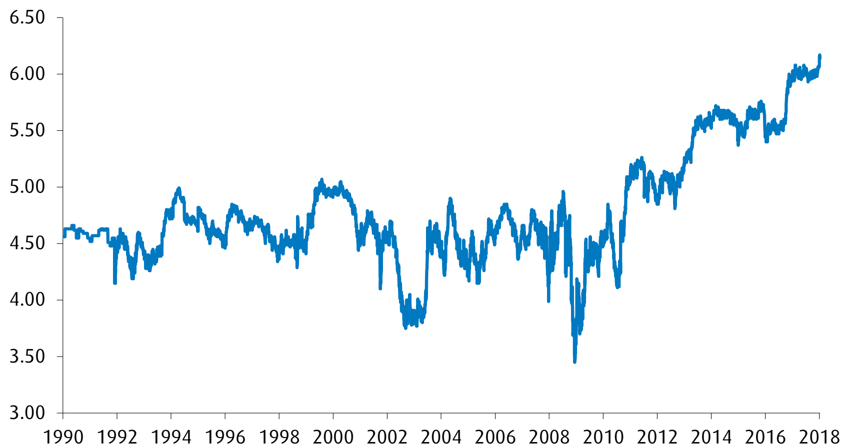
Figure 5: Canada 10-30 Year Yield Spread



Source: Bloomberg

Furthermore, the insatiable appetite for investment return has not only led rates lower but has driven credit spreads to the tightest levels since the financial crisis. This has pushed the interest rate sensitivities or duration in many cases closer to new highs. As an example, the duration[1] of the Bloomberg Barclays U.S. Aggregate Bond index has reached the highest level since the early 1990s, as shown in Figure 6. This means that smaller changes to interest rates will have a more negative impact on performance and could lead to a more significant pullback in markets than would be warranted by fundamentals.

Figure 6: Barclays Duration Index



Source: Bloomberg, Barclays

Technically, the last run up in yields has pushed the market into oversold territory. Reports are indicating that large fixed income speculators, including hedge funds, have increased their bearish bets on 10-year U.S. treasuries to a record high lately which may mitigate further technical deterioration but certainly not eliminate it. We are not yet convinced that inflationary pressures are returning, but we have to protect against volatility and position portfolios accordingly. From an asset allocation perspective, we have been recommending an underweight fixed income allocation for some time now as the low yield environment meant two things for investors: 1) the need to lower future total return expectations and 2) to increase the focus on preservation of capital and income.

Considering the current environment, we believe further reduction in risk exposure is warranted. We recommend reducing duration or interest rate sensitivity by 5% to 10% in both Canadian and U.S. dollar portfolios to a more defensive position against the respective benchmarks. While the easiest way would be to sell longer term exposure and increase cash, we believe that short-term investments remain expensive compared to other available investment options. Instead, we recommend considering a floating interest rate structure that would include government bonds and investment grade corporate securities. Floating Rate Notes (FRNs) offer protection from the pain that rising rates can bring, while also allowing investors to earn some return on their money versus just holding cash. They are a very defensive play, but can help generate outperformance in times of market tumult. In addition, their regular rate resets allow investors to capture some upside in a rising rate environment. Note that this should not be construed as a recommendation to invest in the Senior Loans, a non-investment grade security and more risky sector as we prefer to focus on better quality at this stage.

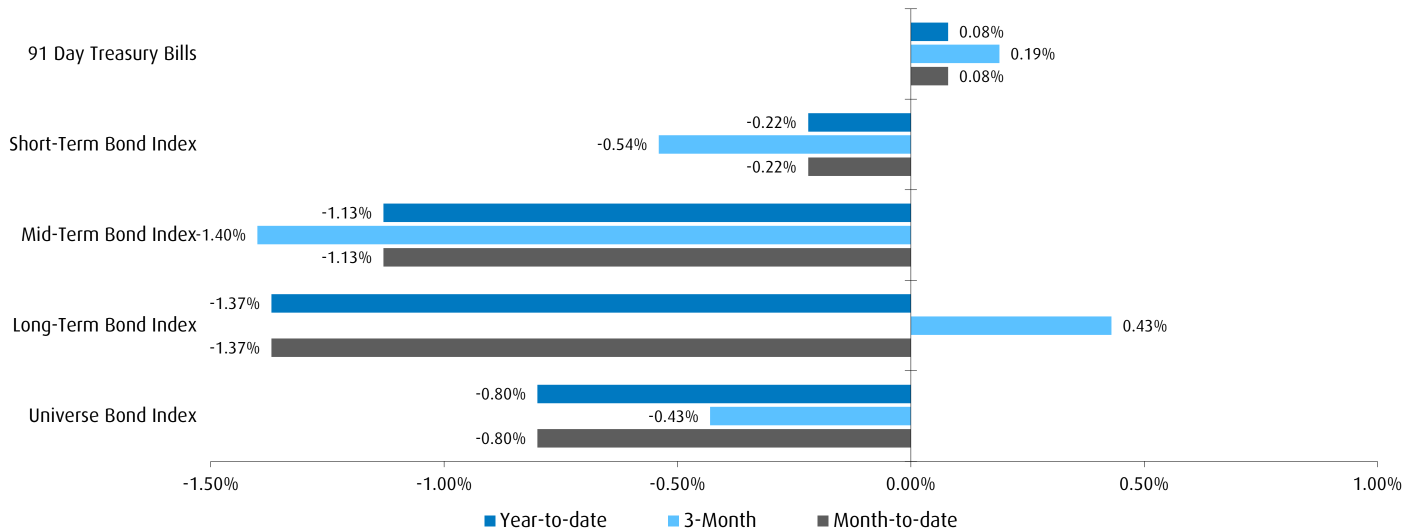
For Canadian portfolios, we recommend reducing exposure to Canada and Canadian agencies in the mid-term sector and use the proceeds to buy a floating rate ETF. Since the FRN market is relatively small and illiquid versus the general bond market, we believe an ETF is an easier way to achieve this exposure. Our preferred option is the Horizon Active Floating Rate Bond ETF (Ticker: HFR) which invests in regular coupon paying bonds but hedges the interest rate risk to offer a lower term exposure / duration risk.

In U.S. portfolios, last year, we recommended to buy the SPDR's Investment Grade Floating Rate ETF (Ticker: FLRN), but to further shorten duration, we recommend increasing its allocation and reducing the exposure to both the mid-term treasury and the mortgage-backed sector.

For more details on FRNs, please contact your BMO Nesbitt Burns Investment Advisor.

[1] Duration measures the sensitivity of a bond price to the change in interest rates in number of years

Figure 7: FTSE TMX Universe Bond Index Returns (for the period ended January 31, 2018)



Source: FTSE-TMX

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