Portfolio Advisory Team

Portfolio Management

September 2017

Fixed Income Strategy

Bank of Canada: Is it the Beginning of a New Cycle?

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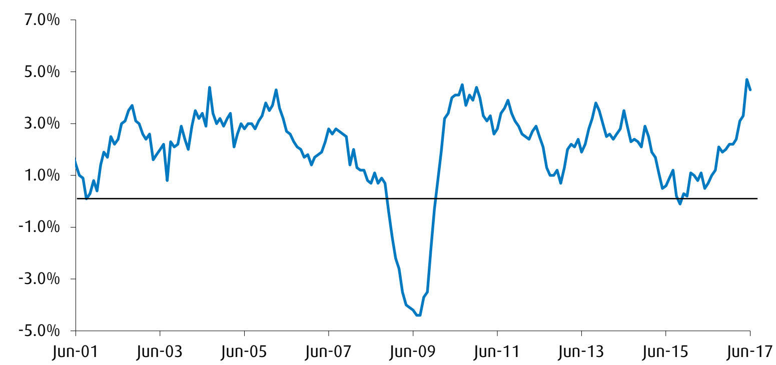
The Canadian bond market slightly recovered in August as yields pulled lower from a renewed global flight-to-safety amid heightened geo-political risks. This contrasted with the summer trend that saw 5 and 10 year government yields rise following a Bank of Canada (BoC) policy shift. However, the celebration was short lived as the BoC decided to raise rates again by 25 basis points (bps) in the early days of September, six weeks earlier than expected as reports indicated continued strong growth in the second quarter.

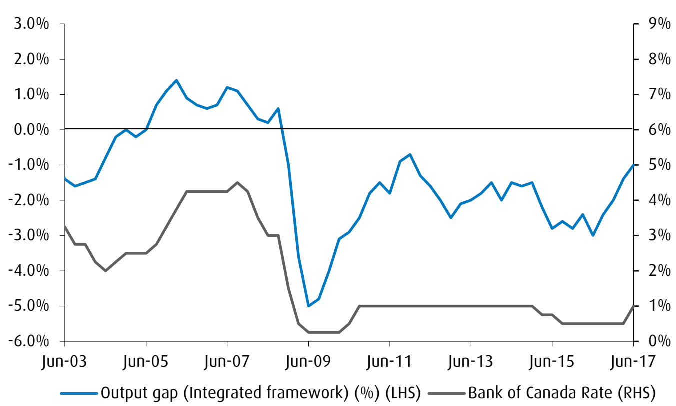
The market had expected a 25 bps rate hike to come later at the October meeting. However, the market seemed more surprised by the statement's language than by the earlier rate hike decision. In particular, the BoC seemed to open the door for further rate increases as it believes that the two hikes this year have served to remove only *some* of the considerable monetary policy stimulus. Also, the fact that the BoC governor Stephen Poloz decided to raise the policy rate despite the strength of the dollar, limited Q3 economic data available, uncertainty around NAFTA negotiations, limited inflationary pressures, North Korea tensions and without the market conviction, indicates that for the BoC *not* to hike again soon would require a significant shift in direction. The market has already priced another hike for the December meeting and the odds remains elevated for an October decision. Following last week's decision, BMO Economics is now looking for another four hikes before the end of 2018 to bring the bank rate to 2%.

Figure 1: Canada Gross Domestic Product (Year over Year)



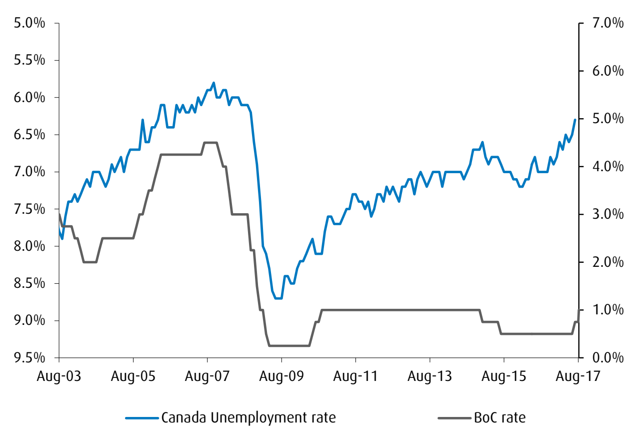
Source: Bloomberg

Figure 2: Canada's Output Gap vs the Bank of Canada Rate



Source: Bloomberg

Figure 3: Canada's Unemployment Rate vs the Bank of Canada Rate

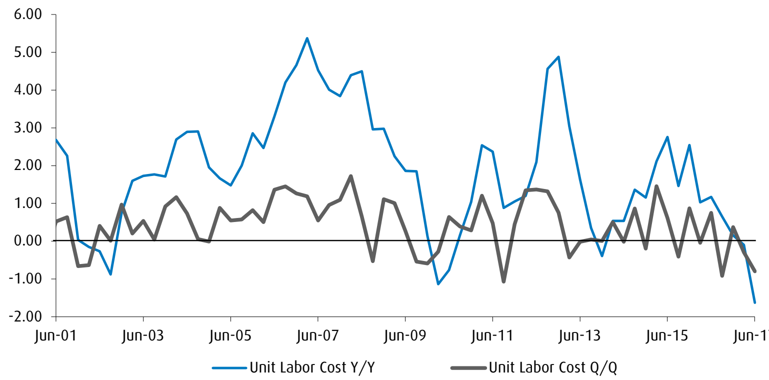


Source: Bloomberg

The BoC did acknowledge that future decisions will be data-dependent, singling out the loonie and inflation as two variables to be closely monitored. The BoC's statement addressed the possibility that weakness in wages and inflation along with moderation in economic growth may warrant a pause in the cycle, making us question whether things are looking prettier from the rear view mirror!

While there seems to be fewer factors supporting low rates, we are not yet convinced that the low yield cycle is over, as Canada continues to be plagued by the same global issues of low inflation and limited wage growth, both of which are below that in the U.S. The Canadian Core Consumer Price Index (CPI) (stripped of the most volatile items like food and energy) has been around 1.5%, below the 2% BoC's target. And, as BMO Economics has pointed out, the BoC's old measure, the CPIX (CPI excluding mortgage costs) is less than 1%. But more importantly, the growth in wages in comparison to the U.S. has significantly disappointed with the most recent quarterly reading showing a deceleration of 1.6% in Q2, one of the worst quarters in over 15 years.

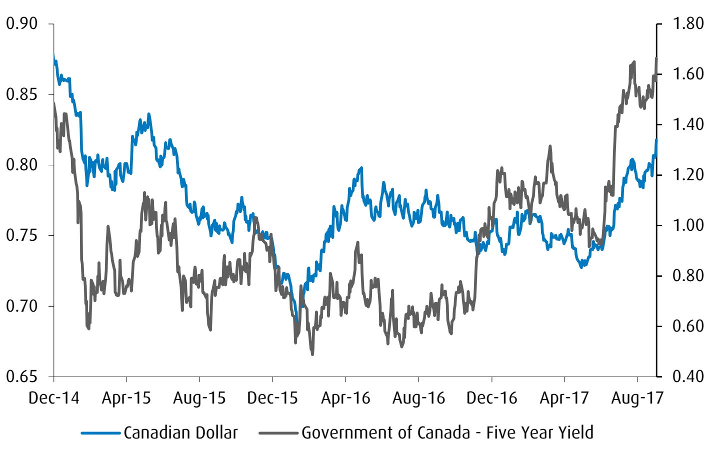
Figure 4: Unit Labour Costs and CPI



Source: Bloomberg

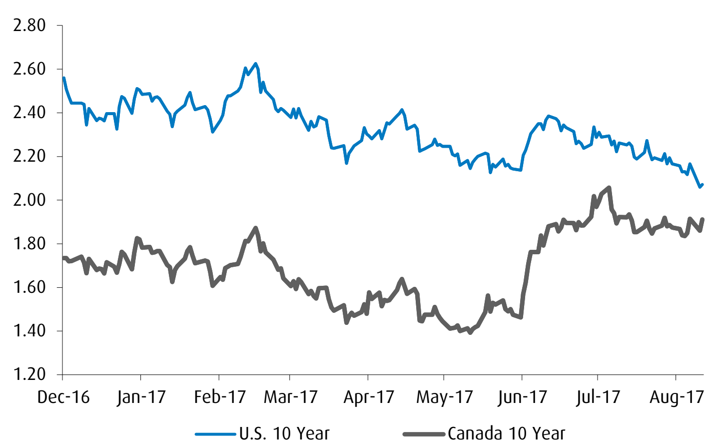
It is possible that inflation will creep up later in the cycle, but it is uncertain and unexpected. However, low inflation had no bearing on short term rates as they resumed their ascent following the BoC's decision. Furthermore, rising Canadian rates at the time when the U.S Federal Reserve (Fed) shifted focus to its balance sheet reduction instead of policy tightening provided an additional boost to an already strong Canadian dollar, as shown in Figure 5. It contributed to the Canadian fixed income markets continued underperformance compared to the U.S., leading to further decoupling of Canada and U.S. yields which moved against their historically strong correlation, as shown in Figure 6.

Figure 5: Canadian dollar and Canada 5 year yield



Source: Bloomberg

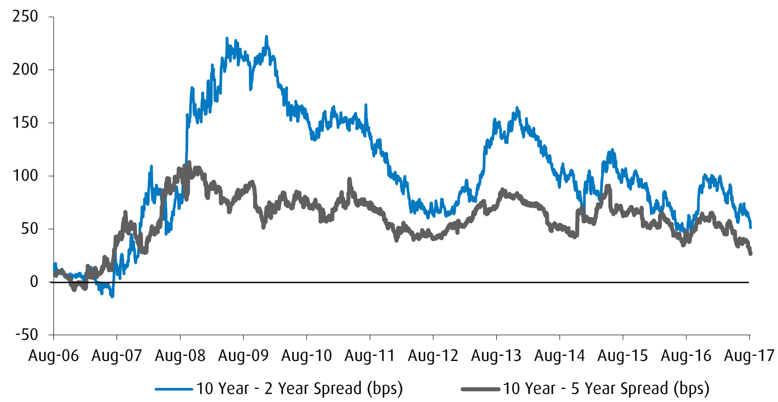
Figure 6: Decoupling of Canadian and U.S. Yields



Source: Bloomberg

The longer term sector was also affected by the tightening but the impact was more muted due to the inflation outlook. This helped explain why despite the BoC's policy changes, the yield curve flattened further, a trend that we believe may still have a bit more room to go, as we have stated in past reports. We note that with the exception of the 2006-2007 period, this is the flattest the 10-year and shorter yield curves have been. In early September, an investor was only getting paid between 25 and 30 bps more to extend from a Government of Canada bond with a 5 year term to one with a 10 year term.

Figure 7: Canada Yield Curve Spreads



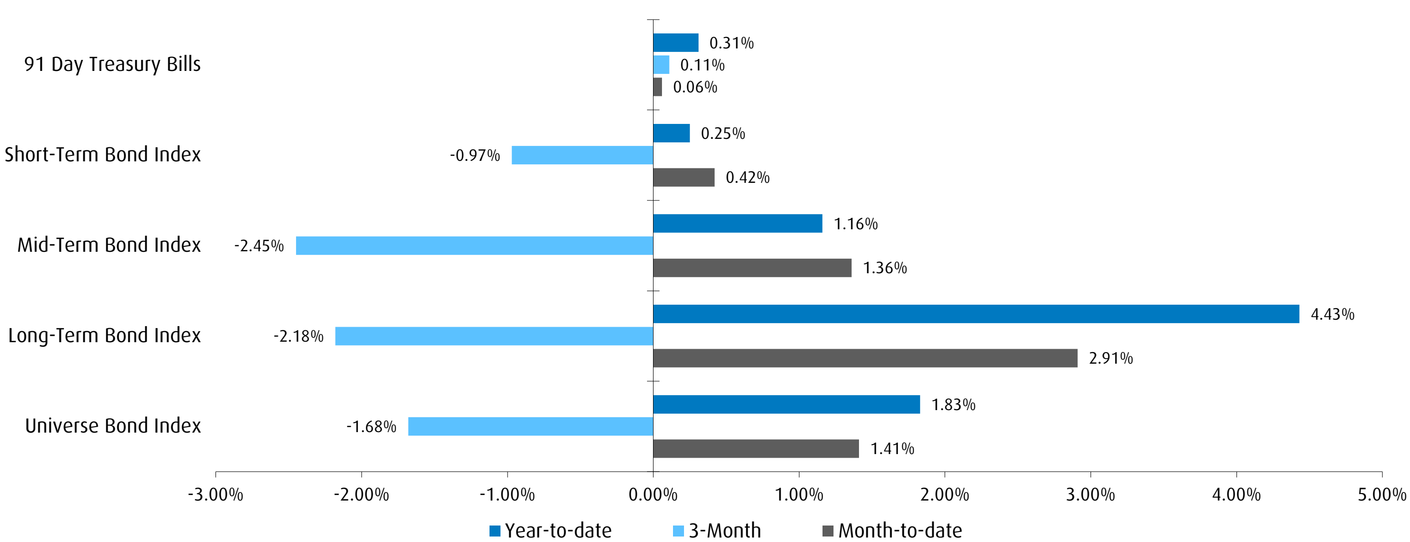
Source: Bloomberg

During that time, U.S. interest rates continued to be pulled lower as the economy continues to face multiple short-term headwinds. The news of the debt ceiling being suspended until mid-December provided temporary relief. However, investors remain concerned with the escalating tensions with North Korea, the nagging issue of low inflation, Trump's inability to reform health care and the tax system, and now the hurricanes; all factors to likely contribute to slower growth in the second half of the year; an environment that should lead the Fed to be more dovish in the near future. Ultimately, this may help mitigate the rise in Canadian yields as observed in August. As U.S. and global yields trend lower, it could temporarily pull Canada's interest rates along for the ride for a while.

From an investment perspective, our recommendation to maintain slightly higher interest rate sensitivity did not benefit investment portfolios lately. We understand that there are fewer factors supporting even lower yields in Canada, but we believe it is too soon to change our view to a more neutral or even a defensive stance. Considering the flatter yield curve, we would be more prudent and selective at this juncture before re-deploying income and maturity in the mid- to long term sector. With the back-up in yields, our focus is shifting toward the four to seven year sector. While our recommendation initially did not account for an early shift in the BoC's policy, the continued lack of inflationary pressures further confirmed in recent data releases is in-line with our forecasts and is supportive of our investment strategy. Furthermore, we understand that the strength of the Canadian dollar and the rise in energy prices may provide a temporary boost to inflation, but it will also likely have an impact on consumption; all of this is in line with the expectations for growth to decelerate in the second half of the year.

Bond Index Returns

Figure 8: FTSE TMX Universe Bond Index Returns (for the period ended August 31, 2017)



Source: FTSE-TMX

General Disclosure