Portfolio Management

November 2017

Fixed Income Strategy

A More Dovish Message from the Bank of Canada

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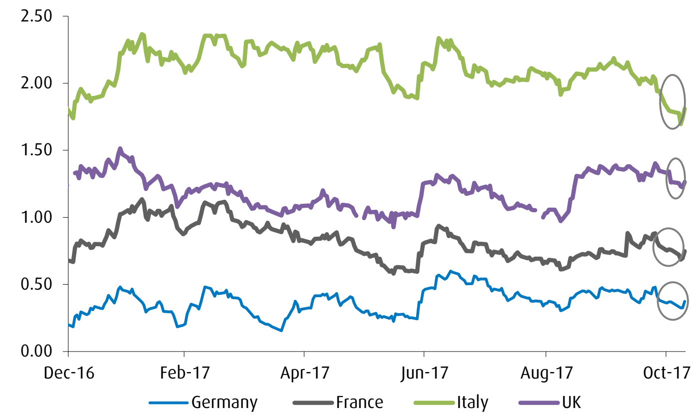
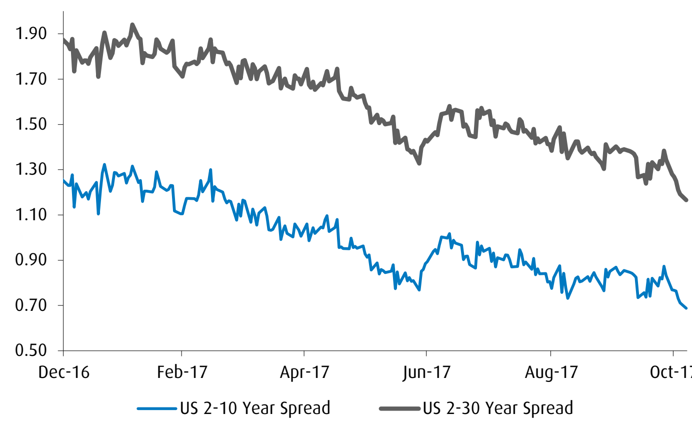
Two more major central banks became less accommodative in October following the steps of the U.S. Federal Reserve and more recently the Bank of Canada (BoC). After hinting at an upcoming policy decision, the Bank of England (BOE) decided to reverse its August 2016 Brexit emergency cut and raised its bank rate by 25 basis points (bps) for the first time in more than a decade. Second, the European Central Bank (ECB) announced it would taper its bond purchase program, scaling it down by 50% to 30 billion euros per month starting in January and continuing until at least September 2018. While the early signs of the BOE's tightening had an initial impact on rates in the United Kingdom (UK), the announcements by both the BOE and the ECB had overall a limited pressure on European rates. In fact German and French rates, two of the largest Euro area bond markets saw their yields move lower during the month, indicating that while purchases will be reduced, these are only small steps to slow the amount of stimulus to the economy.

Figure 1: Germany, France, Italy and United Kingdom 10-Year Government Yields



Source: Bloomberg

Figure 2: U.S. Treasury 2-10 and 2-30 Year Yield Curve



Source: Bloomberg

The same could not be said about U.S. rates that grinded higher, with the increase in the short term sector, represented by the 2-year yield, outpacing the longer term sector. The Fed's reduction in its maturity reinvestment program however was not seen as the primary driver. Instead, it was the uncertainty surrounding the nomination of Janet Yellen's replacement as Fed Chair, and further indication that the economy remained on solid footing in Q3, that further strengthened the case for another Fed rate hike in December. The uncertainty around the Fed Chair replacement was resolved on November 2nd, as Jerome Powell was nominated*. Furthermore, the Senate's approval of the budget was perceived as another step towards a new tax reform, which would be positive for economic growth, even if it remains unclear what the President will be able to get approved. With the risk of rising long term rates mitigated by inflation expectations still anchored around 2.50%, the rising short-term rates on the prospect of further tightening contributed to the yield curve further flattening to levels not seen since 2007.

**The President's nomination must be confirmed by the Senate Banking Committee and by the Senate*

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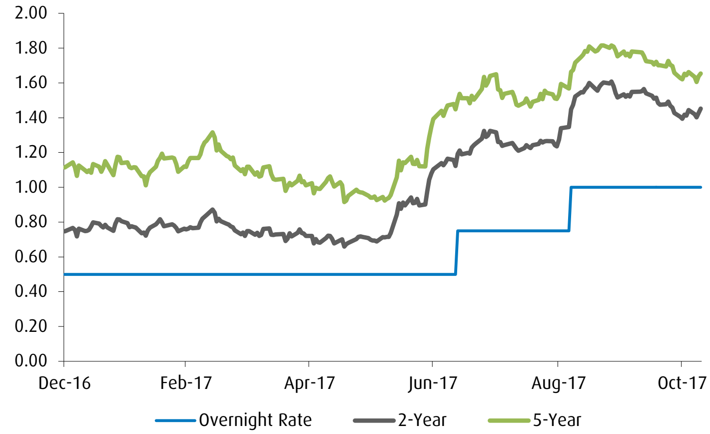
In comparison, after seeding monetary policy uncertainty earlier this year, the BoC adopted a more cautionary approach to its tightening cycle. Following 50 bps of cumulative hikes in the previous two meetings, recent evidence that the economy likely decelerated led the Bank to issue a more cautious statement and leave its policy rate unchanged. The BoC stated that the U.S. trade negotiations (NAFTA), changes to the Office of the Superintendent of Financial Institutions (OSFI) mortgage rules, weaker exports and elevated household debt levels would contribute to economic growth moderating to “a more sustainable pace in the second half of 2017, remaining close to potential over the next two years.” This led investors to delay expectations for the next rate hike into the first quarter of 2018, helping the loonie weaken and Canadian bond yields move lower. BMO Economics now pencils in the next rate hike for March 2018. This contributed to the Canadian fixed income market outperforming in October, moving year to date total returns to positive territory, and erasing the Q3 losses which was one of the worst quarters for bonds over 15 years.

This hasn’t stopped the BoC from indicating that the economy is likely running close to its potential but it admitted that wage growth and other data continue to point toward further slack in the labour market. So despite the recent hikes, the BoC remains concerned about the downside risk to inflation. From an investment perspective, this tells us there is more room for growth before bond investors start to worry about inflation rising materially above target. This also means that the risk of higher rates remains low as the need for more aggressive tightening is reduced. As a result, despite the less hawkish bias, the prospect of expected tightening combined with low inflation has allowed the curve to resume its flattening trend.

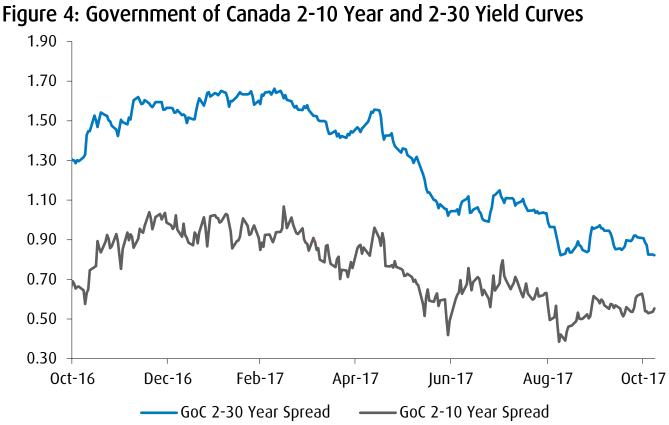
While the economies are on slightly different paths, the flatter U.S. and Canadian yield curves are raising questions. A flattening yield curve is normally linked to an economic expansion that is aging and as the central bank tightens it may lead to an inverted yield curve, indicating a recession may be closer. However, as BMO’s economist Doug Porter highlighted, while flatter, the curve is not yet flat or inverted and we may have a long way to go before this can happen. As an example, he noted that when the U.S. yield curve reached a similar level in 1994, it took six years for the economy to effectively stall. It may be too early to feel threatened, but conversely we have to remind ourselves that we are only approximately three rate hikes away from an inversion in the U.S. 2-10 yield curve and two hikes away in Canada. The easy conclusion would be to start forecasting a recession, but in our opinion this seems to

Figure 3: Canada Overnight Rate, Government of Canada 2-Year and 5-Year Yields



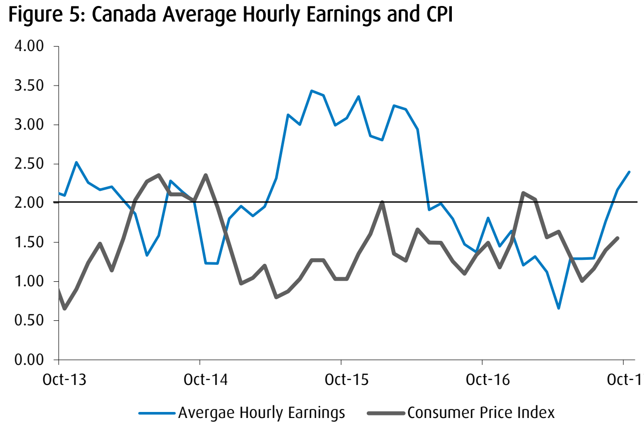
Source: Bloomberg

Figure 4: Government of Canada 2-10 Year and 2-30 Yield Curves



Source: Bloomberg

Figure 5: Canada Average Hourly Earnings and CPI



Source: Bloomberg

be too early as the current economic momentum on both sides of the border does not yet suggest such an outcome.

The question is whether the flattening trend can persist: we think it can, especially in the context of central bank tightening policy persistent low inflation. However, historically speaking, inflation has risen late in the economic cycle, and this time may not be different. We continue to look for signs that would change our view. While Canada has experienced very low wage gains (that are even lower than the U.S.), earnings growth has accelerated lately on the back of strong labour gains. Rising oil prices may change the dynamic for economic growth and labour markets. In the most recent labour report, Alberta was the second strongest contributor of job gains in Canada. Let's not forget that prior to the 2015 energy slump, close to 40% of Canadian jobs were created in Alberta. The BoC reiterated that it will be guided by incoming data for future monetary policy decisions and potential removal of the stimulus in the economy. Any indication of either rising inflation or stronger growth could change the current expectations of the tightening path.

In this environment, we continue to favor a neutral duration compared to investor's benchmark (we remind readers that duration measures interest rate sensitivity of a portfolio). The combination of low inflation and the slow removal of monetary stimulus should contribute to low interest rates and a flattening yield curve.

Improving Credit Quality: Eliminating Exposure to the U.S. Senior Loans Sector

The corporate bond sector, both investment and non-investment grade, has generated strong performance since early 2016 as energy markets recovered and credit spreads tightened significantly. The search for yield pushed investors into riskier fixed income investments as yields in general continued to move lower. Unfortunately there is more complacency with risk, a reality reflected in part by the record low level of volatility in treasury bonds, as demonstrated by the MOVE Index in Figure 6. We were early last spring in reducing our exposure to credits as spreads tightened on good corporate earnings and as benchmark yields rose. Back then, we reduced exposure to longer term non-investment grade credits but maintained our recommendation for both higher beta investment grade credits and U.S. floating rate senior loans that could benefit from rising Fed Funds rate.

Figure 6: MOVE Index

Source: Bloomberg, Merrill lynch Option Volatility Estimate

However, as corporate spreads continued to tighten in October towards levels last seen in 2007, just before the financial crisis, we recommended improving the overall credit quality of fixed income portfolios by further reducing exposure to lower investment credits in the mid-term sector, mainly eliminating our BBB credit exposure in the 5 to 10 year sector. In early November, we also recommended to eliminate exposure to the U.S. Senior Loan sector. For over three years, we recommended gaining exposure to the sector using the First Trust Senior Loan ETF (FSL). In recent weeks, we saw the U.S. High Yield spread widening by 40 bps and over US$2 billion worth of deals that were pulled from the primary market due to lack of demand. We have also witnessed a large selloff in the non-investment grade ETF since early November, signs of potential stress in the sector. This is not only a U.S. phenomenon as the Euro Junk Bond index spread widen early November by 30 bps or 13% after seeing its yield drop to a record low only a couple of bps above 5-year U.S. treasury yields. Furthermore, High Yield issuers have benefited for years now from low yield and tight credit spreads. Unfortunately, the tighter U.S. financing conditions may change the primary market landscape as short-term rates are rising and spreads are widening. For these reasons, we prefer reducing risk in this environment to evaluate whether this is a short-term pullback or a longer term correction in credit markets. As it stands, we believe that spreads in general no longer reflect the credit risk embedded in these investments.

Figure 7: U.S. High Yield Spreads

Source: BofA Merrill Lynch

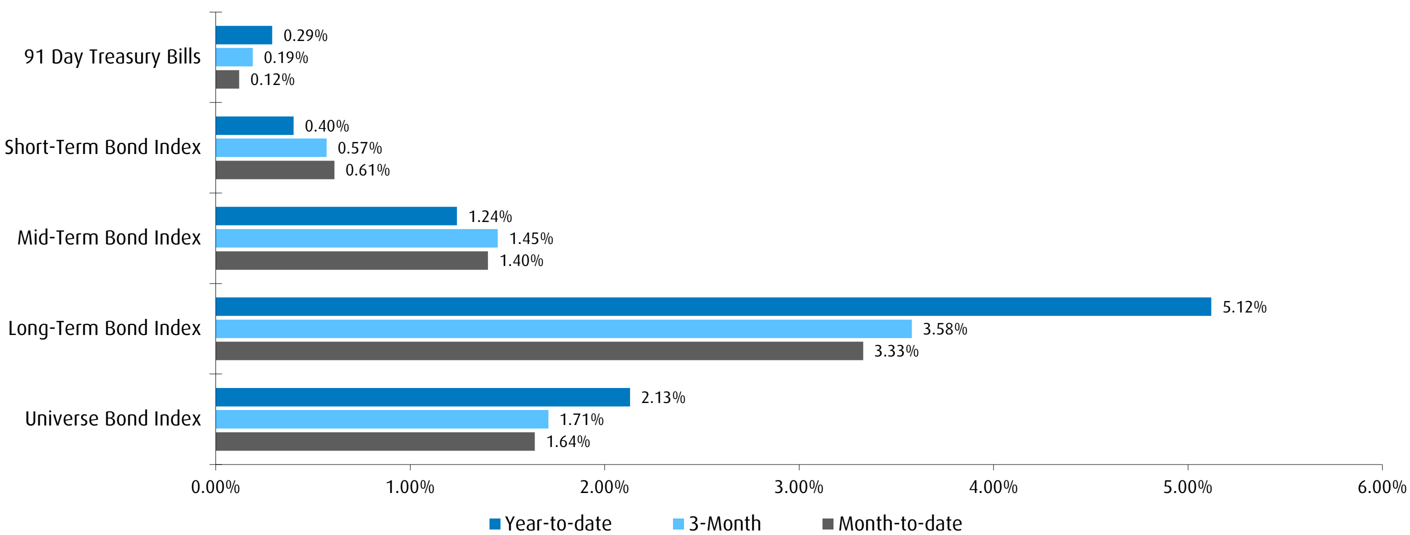
Figure 8: Euro High Yield Bond Yields – Reaching Record Lows

Source: BofA Merrill Lynch

We realize that credit cycles are very difficult to nail, and despite the low compensation, the insatiable demand for yields has driven and may continue to drive these sectors into even loftier valuations. Since our primary objective remains the preservation of capital, we prefer at this stage to be more conservative even at the risk of leaving a bit of yield on the table. As for the proceeds, we recommend reinvesting these funds in government or better quality corporate names in the 3 to 5 year sector.

Bond Index Returns

Figure 9: FTSE TMX Universe Bond Index Returns (for the period ended October 31, 2017)



Source: FTSE-TMX

General Disclosure