Portfolio Management

October 2018

Fixed Income Strategy

Global Monetary Policies are Becoming Less Accommodative

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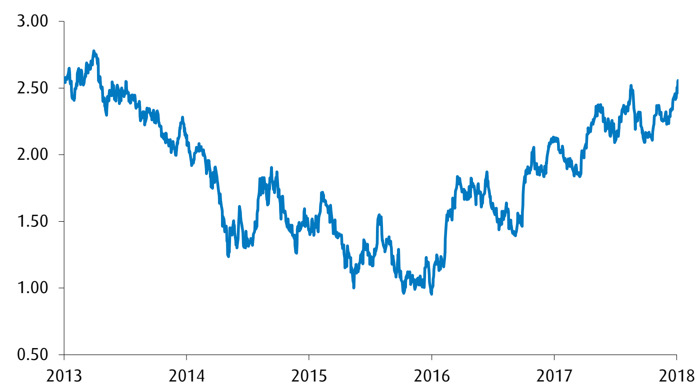
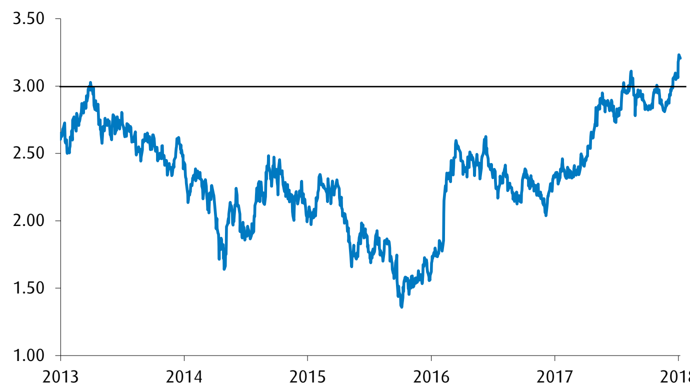
Finally, after testing the 3% level multiple times over the last year, the 10-year U.S. Treasury yield rose firmly above last May's peak of 3.11%, entering the fourth quarter at the highest level since 2011. This move pulled global rates higher including the Canada 10-year yield which rose above this year's peak of 2.52%. To say that this was expected would be an understatement. In fact, the size of bearish bets on the level of 10 year interest rates (as expressed by the total short speculative position on 10-year treasury futures) was at record levels in recent weeks. The question should not be about why it happened but really why now. Back in May 2018, when the 10-year U.S. Treasury first traded above 3%, we answered the "why now" by stating that: *the combination of better economic forecasts, strong corporate earnings, record quarterly U.S. treasury issuances, rising wage gains and inflation were likely the factors behind the push.*

Figure 1: Government of Canada 10-Year Yield



Source: Bloomberg

Figure 2: U.S. Treasury 10-Year Yield

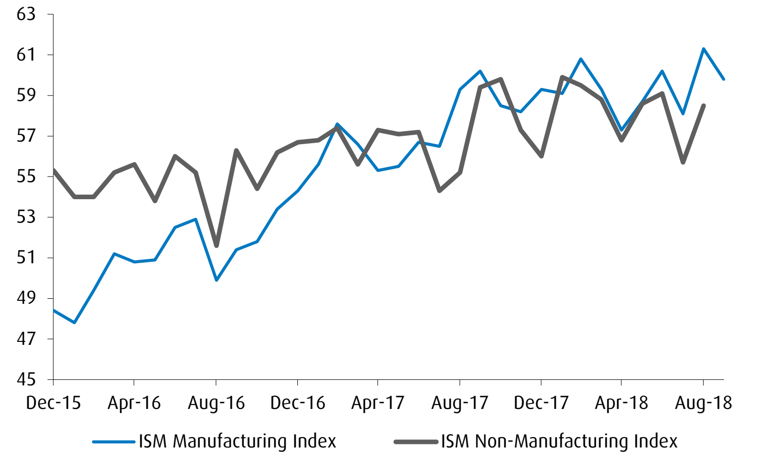


Source: Bloomberg

This time around, we face the same questions but the drivers seem to have changed. Despite the perception that the current economic cycle is maturing, there is no denying that the U.S economy remains strong, led by a tight labor market and a strong service industry. The housing sector may no longer carry the same economic weight as in the recent past and household credit growth has definitely slowed, but there is enough to sustain economic growth and continue to lead rates higher (net of inflation), something investors have been longing for. In fact, with inflation expectations relatively stable over the last couple of months, not only has the 10 year real rate risen above 1%, but the real Fed Funds Rate (the Federal Reserve's short term rate) has turned positive, something that hasn't been seen since May 2008. This is a sign that the Fed is becoming less accommodative.

There is more to the story. First, the renewed free-trade agreement is removing a cloud of uncertainty over markets and the economy, which should help business investment and overall growth in the second half of the year (including Canada); this is a definitive catalyst that will help lift real rates. Second, recent more hawkish remarks from the U.S. Federal Reserve Chair Jerome Powell who expressed an upbeat view of the economy and limited concern over inflation are supporting further rate increases. In particular, his observation that short term rates remain accommodative at 2.25% (for the Federal Funds Rate) leaves more room for further hikes before reaching neutral territory and re-affirms the Fed's intention of maintaining its gradual tightening path. More important was the suggestion that the Fed could lift policy rates above neutral if required. This not only confirmed the path but practically penciled in another hike at the December meeting.

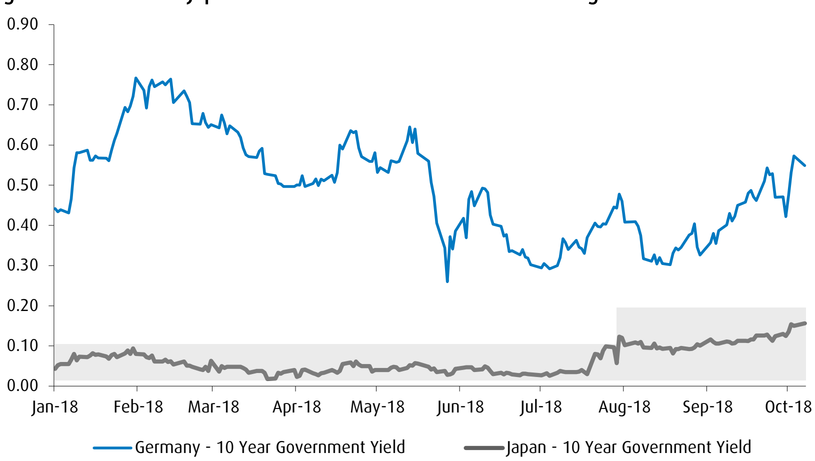
Figure 3: ISM Manufacturing Index (left side) and Non-Manufacturing Index (right side)



Source: Bloomberg

Lastly, the Fed is no longer alone in its tightening exercise as other central banks are joining in the task of gradually removing excessive monetary stimulus, helping push global rates higher. Our focus has been primarily domestic, with the Bank of Canada's expected to hike again this month. However, October also marks the beginning of the end for the European Central Bank Asset Purchase program. The European Central Bank (ECB) has cut its monthly purchases in half to 15 billion euros until December, at which point it is set to end, which has been reflected in the rise in German bond yields. Even the Bank of Japan, which had been targeting a 10-year government bond yield range between ±10 basis points, is now allowing the acceptable band to widen to ±20bps. The combination of tighter monetary policies is contributing to rising global rates, a trend that is likely to persist for the moment.

Figure 4: German and Japan Government 10-Year Bond Yields Rising

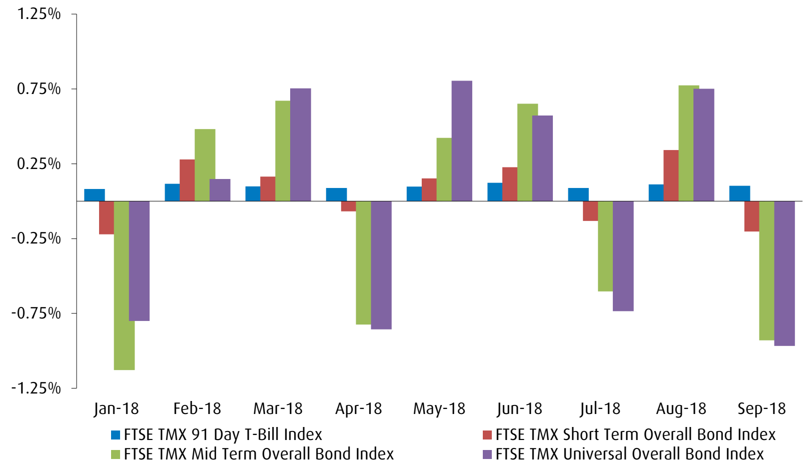


Source: Bloomberg

Market Recap

Unfortunately, the interest rate movements have resulted in increased volatility and weak performance – fixed income portfolio returns have been on a rollercoaster so far this year and the 3rd quarter was no exception. In Canada, the bond index, as represented by the FTSE TMX Universe, has generated negative total returns of -0.96% for Q3 and -0.35% year to date. The shorter maturities, as represented by the FTSE TMX Short-Term Universe comprising of securities maturing between 1 and 5 years, generated a positive return of +0.54% for the first nine months of the year, despite seeing the sector's government rates rising on average by 60 basis points during the period. As it is often the case at this stage in the economic and monetary policy cycles, investors have favored shorter maturities to reduce price sensitivity to changes in interest rates. Rising yields will lead bond prices lower and, in general, the shorter the maturity, the less volatile a bond will be for a stated yield change.

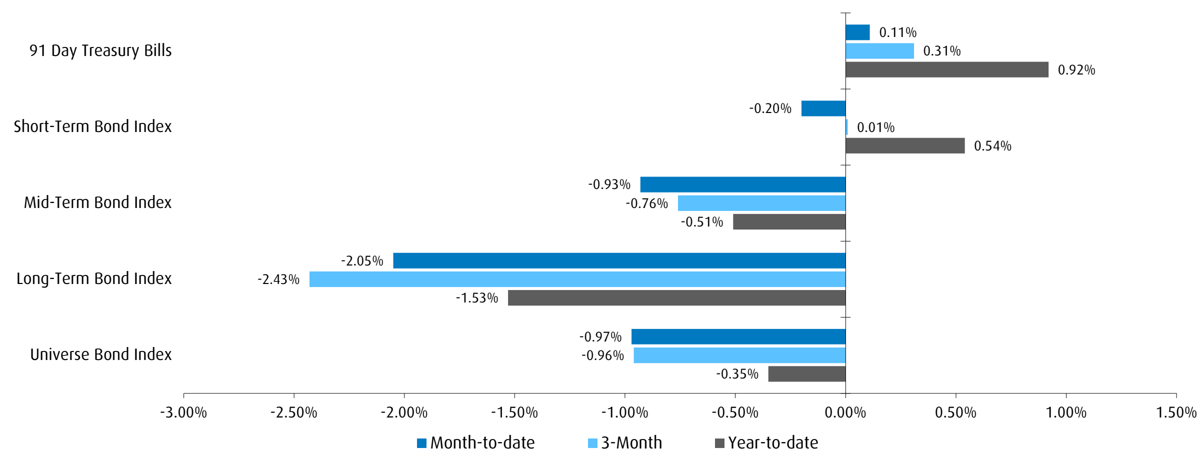
Figure 5: Rollercoaster Monthly Returns in 2018



Source: Bloomberg

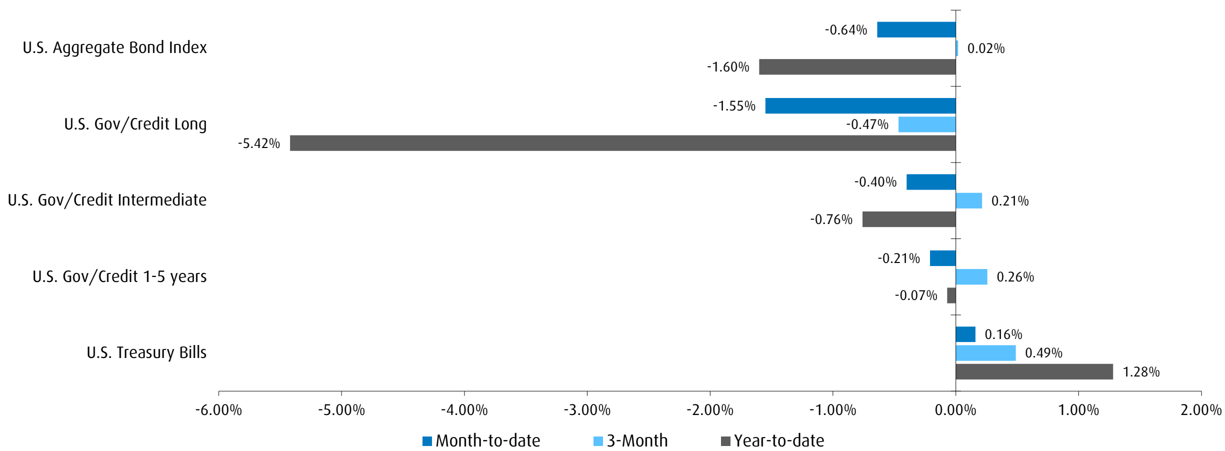
The best performance in 2018 has come from securities with under a year to maturity, like treasury bills, bankers acceptances and commercial paper. In particular, the safest investment in the group, the Canada Treasury Bills have returned +0.31 for Q3 and +0.92% for the first nine months despite yields rising 55 basis points to 1.60%. These securities not only have the advantage of carrying limited price sensitivity due to the very short maturities but also investors can continuously roll maturing securities into higher yielding ones. We see a similar trend in the U.S. where short term securities have outperformed but we note that due to the more aggressive Fed and the more significant rise in interest rates, this has led to a larger return difference between shorter and longer term maturities.

Figure 6: FTSE TMX Universe Bond Index Returns (for the period ended September 30, 2018)



Source: FTSE-TMX

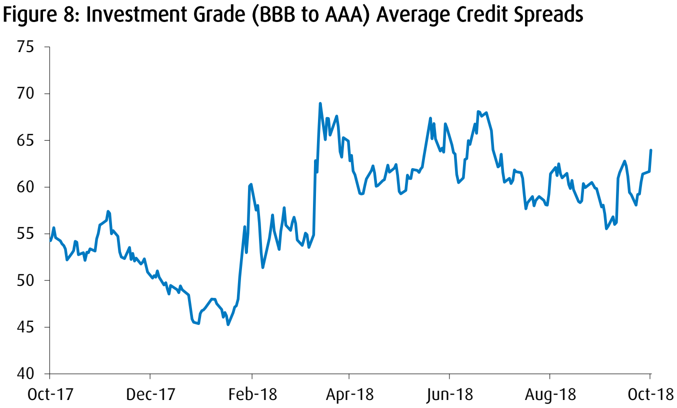
Figure 7: U.S. Bond Index Returns (for the period ended September 30, 2018)



Source: Barclays

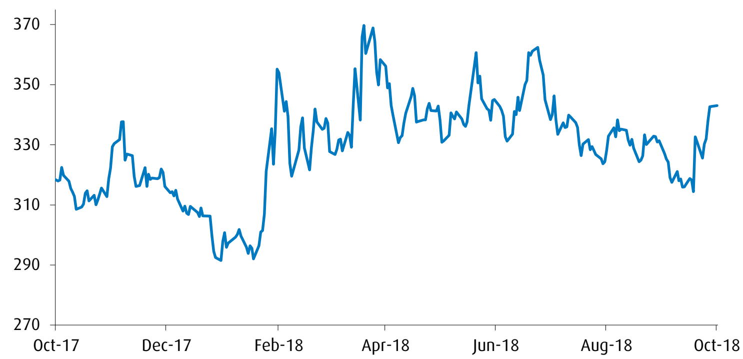
Selectively, some corporate bond sub-sectors have outperformed in their respective term ranges. This was again led by investors' thirst for higher yields supporting corporate credit spreads, though we started to see some deterioration in the sector late in September, particularly for riskier securities. The Canadian and U.S. corporate bond markets have performed very well in the last couple of years but credit spreads have failed to re-test their tightest levels of the last two years. This makes some sense for Canada as the pace of economic growth has slowed down since 2017, reflecting higher business risk, but not for the U.S., where growth has improved. In fact, what may be limiting further spread improvement beyond the fact they are already relatively tight is the fact that the general level of interest rates have also risen. For issuers, this means higher funding costs in the near future; costs that can continue to rise assuming further central bank tightening and re-normalization of the yield curve.

Figure 8: Investment Grade (BBB to AAA) Average Credit Spreads



Source: Bloomberg

Figure 9: Non-Investment Grade/High Yield (BB and lower) Average Credit Spreads



Source: Bloomberg

Worse, there is another trend that is becoming more concerning: the average quality deterioration of the corporate bond universe. Not only have we seen significant growth in non-investment grade securities like High Yield (junk) bonds and Senior Loans, but also in the lower quality sector of the investment grade securities, those rated BBB. In Canada, the total market weight of corporate securities rated BBB at the end of September was more than double where it was in 2006, representing close to 40% of the $455 billion market. In the U.S., BBB rated securities now represent more than 50% of the US$6 trillion investment grade corporate bond market. We may have been early in recommending to transition towards better quality given their outperformance this year, but we continue to believe the combination of tighter monetary policies, higher rates, rising funding costs and a maturing economic cycle will reduce the return prospects for the corporate bond market. Domestic and global default rates are low and, while investors have experienced lower bond prices and portfolio values as rates rise, portfolios have not yet been subject to increased risk of capital losses due to defaulting issuers. However, while these cycles are slow to develop, the current conditions could lead to greater volatility and are worth monitoring closely. We continue to advocate an overweight corporate allocation but with two distinct tilt: we favor shorter term exposure and focus on better quality.

General Disclosure