Portfolio Management

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Fixed Income Strategy

It Looks Like the 3% Target on the 10-Year Treasury Yield Will Have to Wait

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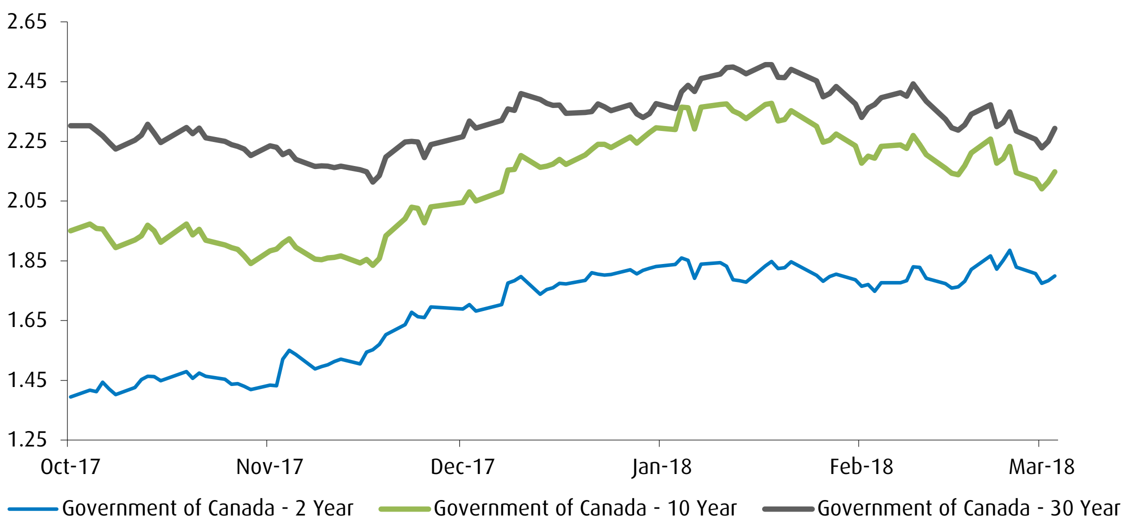
After months of relative underperformance, fixed income investors were faced with the potential impact of tighter monetary policies and higher rates. The combination of favourable U.S. fiscal policies and better global growth prospects meant the end of the low rate era for many market pundits. Even before favourable fiscal policy, the bond market was already doomed by fears of wages and inflation rising above central bank targets. These concerns have yet to be reflected in the markets and if March is any indication, the short term outlook may have shifted slightly from initial expectations.

There remains a bit of a disconnect between central bank actions and investor expectations. Central banks are reducing stimulus, which is pressuring short term rates higher, while low inflation expectations are keeping long term rates low. This is leading yield curves to flatten. There is no doubt that the slow and gradual removal of monetary stimulus is easing the transition to higher rates, but in our opinion, the general optimism earlier this year may have faded a bit, particularly in Canada.

Figure 1: Government of Canada 2, 10 and 30 Year Yields



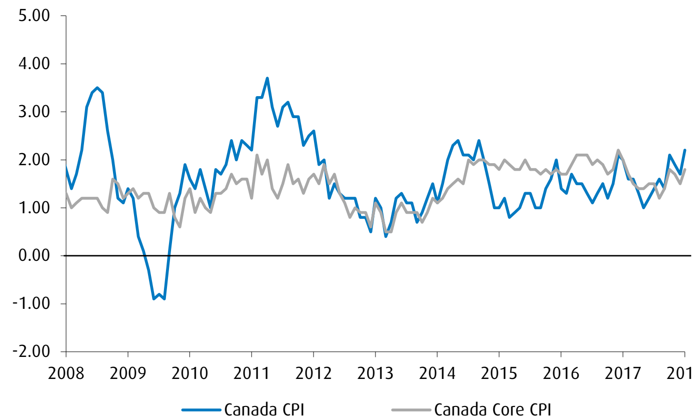
Source: Bloomberg

The contraction in the Canadian economy in January (compared to the surprisingly strong start of 2017) supported Bank of Canada (BoC) governor Steven Poloz's view that there remains some slack in the labor market and the economy, and the need to further reduce monetary policy may not be as pressing as it felt months ago. The GDP miss was a surprise for many and while BMO Economics believes it was sector-specific weakness and not broad-based, it nonetheless demonstrates the relative softness of the Canadian economy. Furthermore, concerns over NAFTA, whether exaggerated or not, and the nagging issue of weak exports are further weighing down the odds of another rate hike this spring. Investors still expect the BoC to lift rates twice more this year, but are leaning toward a move later this summer in July. With policy expectations fully priced in, short- and mid-term government yields are receiving some support, in our opinion. Not even a stronger February Consumer Price Index (CPI), that showed inflation above 2% on an annual basis, could push rates higher.

However, we note that Canada CPI has tended to strengthen in the first quarter of the last three years, only to fade later in the year, which could partially explain the more muted response in yields. For early 2018, we can attribute the higher CPI to some of the rise in commodity prices and the spike in some provincial minimum wages but these are expected to be temporary. Also, the recent drop in housing activity and prices may help alleviate some of the concerns of inflationary pressures.

So far the factors above look to be primarily a Canadian story, as the U.S. does not necessarily share the same supporting factors for lower rates. The latest data may have been somewhat softer but the economy still remains on solid footing, especially compared to Canada. After raising rates last month, the Fed remains on course for at least two more rate hikes in 2018, with upside risk to that forecast.

Figure 2: Canadian CPI (Headline and Core) – Going Back 10 Years on a Quarterly Basis



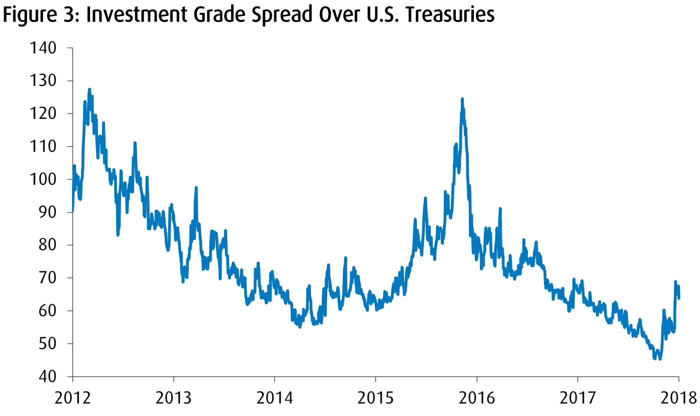
Source: Bloomberg

Surprisingly, however, the U.S. market remains unfazed and mid-to long-term rates are struggling to break out of their recent trading range toward new highs. Let's be honest, many would have thought that a stronger U.S. economy, tighter monetary policy, tax cuts, a slightly more hawkish Fed Chairman, and the Fed's higher GDP expectations would have led U.S. interest rates higher. Not even a tighter labor market, higher wage gains or the expected increase in treasury supply (which will be used to fund the rising government deficit) in March would lead long term rates higher.

Arguably, the U.S./China trade concerns and the significant increase in volatility in equity markets may have led some investors to shift their allocation to more conservative assets, mitigating the rise in interest rates. Having said that though, we haven't witnessed a significant increase in the demand for safe haven assets, like U.S. treasuries and Canadian bonds, that have historically been associated with larger equity market pullbacks. In fact, if that would have been the case, interest rates would have rallied much lower.

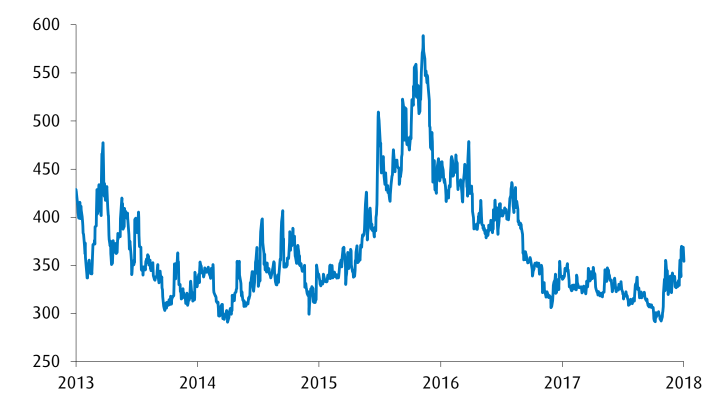
We did observe some customary reaction in the credit markets, reflecting the softer economic data and the increased volatility. But nothing sinister as market valuations had reached lofty levels towards the end of 2017 and into 2018, and it was only normal for investors to start demanding higher compensation for issuer risks, in particular for the high yield or junk bond sector among fixed income investments.

Figure 3: Investment Grade Spread Over U.S. Treasuries



Source: Bloomberg

Figure 4: High Yield Spread Over U.S. Treasuries



Source: Bloomberg

Other factors may have also played a large role in the widening of credit spreads like low rates and foreign demand. The sheer prospect for higher rates has led many issuers to tap the bond market for relatively inexpensive financing. As an example, just in Canada, March was the third busiest month ever for Canadian corporate bond issuances.

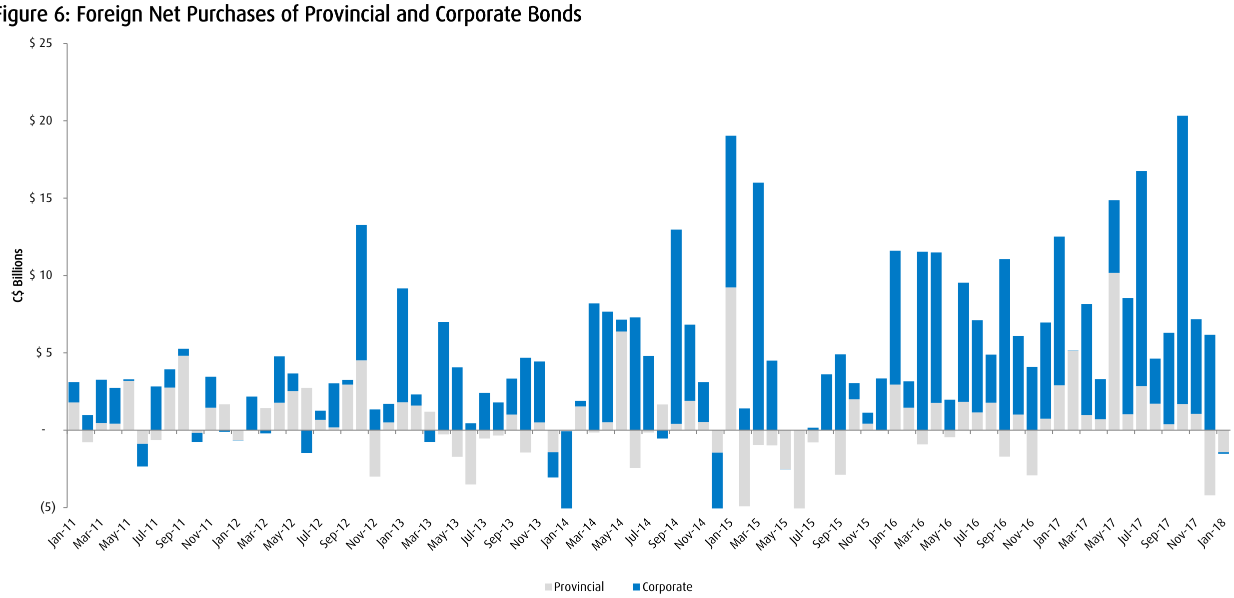
Figure 5: Canadian Corporate Bond Issuances

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
January	4,345	3,650	6,393	9,230	9,771	9,359	6,600	1,940	4,960	7,300	3,350
February	6,180	1,530	2,570	8,813	9,450	5,860	4,046	10,628	6,345	6,921	8,120
March	6,900	4,320	7,523	11,037	2,995	8,875	9,895	17,696	11,250	12,326	16,636
April	9,875	4,255	7,602	9,565	4,945	7,350	8,990	6,540	5,450	6,075	2,500
May	6,040	5,400	5,652	5,830	9,114	9,200	8,242	5,605	6,425	15,343	-
June	10,347	7,542	7,390	4,256	7,205	11,020	10,908	14,297	10,875	10,266	-
July	4,940	3,805	5,476	4,738	7,257	8,695	7,096	8,382	12,275	7,350	-
August	1,850	1,807	3,800	5,600	3,610	8,250	2,677	1,154	6,700	6,075	-
September	4,600	4,450	5,198	2,835	8,939	9,749	9,698	11,879	7,452	10,907	-
October	3,686	4,050	4,230	3,655	9,379	9,778	5,599	7,537	6,253	11,787	-
November	1,000	12,890	9,900	6,474	5,173	13,915	6,995	3,150	6,730	8,005	-
December	2,065	3,830	12,703	6,319	10,425	3,500	6,050	4,075	9,580	11,048	-
Total	61,828	57,529	78,437	78,353	88,264	105,551	86,795	92,884	94,294	113,403	30,606
Monthly Average	5,152	4,794	6,536	6,529	7,355	8,796	7,233	7,740	7,858	9,450	7,652

Source: BMO Capital Markets

Furthermore, the strong foreign demand for government and corporate bonds over the last couple of years had diminished considerably since Q4 2017. In Canada, 2017 was actually a record year for foreign inflows into fixed income markets and both provincial and corporate spreads had benefited significantly, as shown in Figure 6. Spreads may have been more affected by the overall demand than by an increase in issuer risks. We think this may not persist as the higher North American yields may become attractive again to foreign buyers. In fact, due to diverging monetary policy paths, mid- to long-term yield differentials, especially between the U.S. and Europe, are at or close to the widest they have been since the Trump election.

Figure 6: Foreign Net Purchases of Provincial and Corporate Bonds

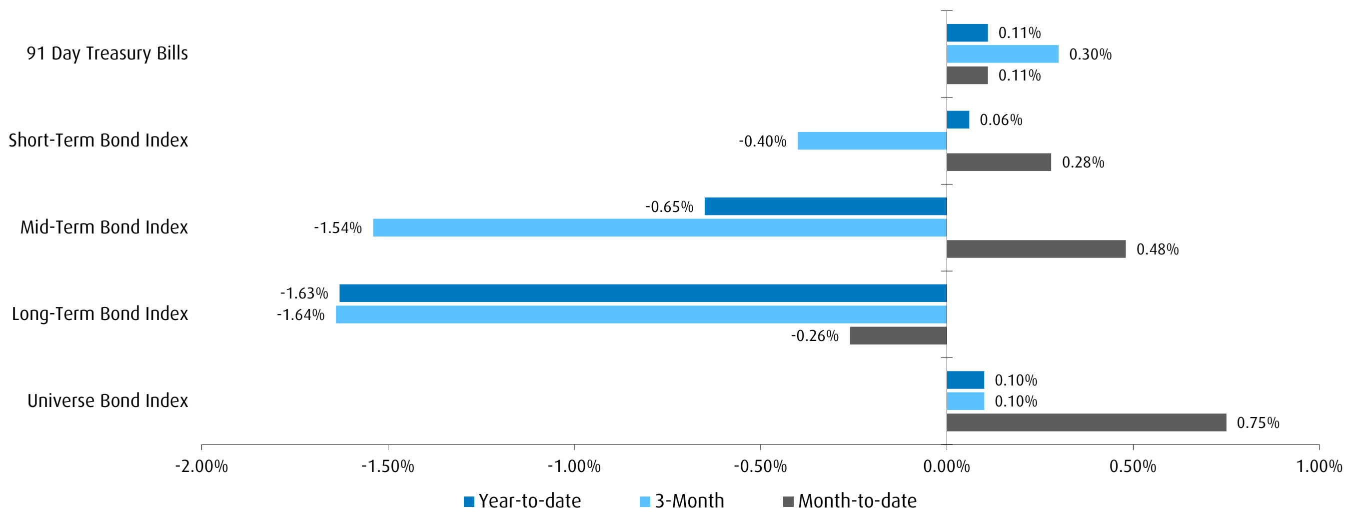


Source: BMO Capital Markets

Overall, considering the U.S. economic environment where growth is moving at a solid clip and the labor market is close to, if not at, full employment, it makes you wonder why interest rates are not higher and the yield curve is not steeper. Either investors are in for a major surprise on growth and inflation trending higher, or maybe the near term prospects are losing some of their shine; we lean toward the latter.

The 10-year U.S. treasury yield is currently trading within a 25 basis point range between 2.70% and 2.95%. It appears the 3% target yield that many expected, may not come for a little while longer. The same could be said for Canada where after reaching close to 2.40%, the 10-year Government of Canada bond yield is now below 2.20% again. While a trade war, NAFTA negotiations and inflation surprises could help break the range to the upside, we doubt the market has enough thrust to significantly move above the range. At best, we think the current environment and outlook will likely continue to support both Canada and U.S interest rates in the current trading range for the time being.

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



Source: FTSE-TMX

General Disclosure