Portfolio Management

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Fixed Income Strategy

Stronger Growth, Rising Inflation Should Lead to Higher Rates...Gradually!

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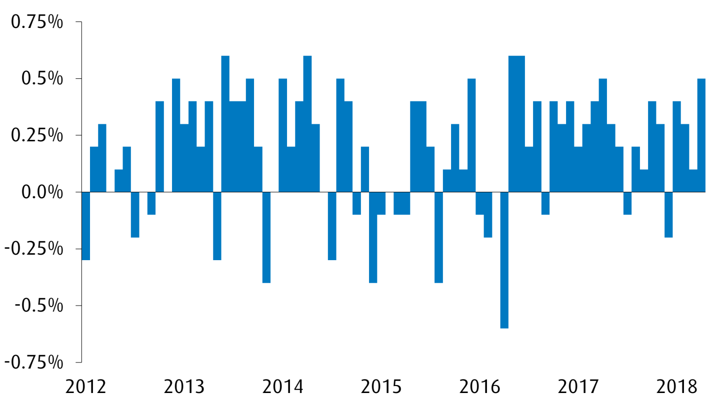
Only weeks ago, we were questioning whether Bank of Canada (BoC) Governor Poloz had convincing arguments to raise rates in July considering that economic growth had hit a speed bump in April due to bad weather and trade uncertainty. In particular, the free-trade agreement negotiation was cited ad nauseam as a major risk to growth. Fast-forward to today and the economic data from May and early June is painting a very different picture that supports tighter monetary policy in Canada. The strong rebound in consumption and housing contributed to Canada posting not only the fastest monthly growth this year in May but also in the last two years, increasing the odds of another rate hike soon. BMO Economics has penciled in the BoC's October meeting for the next potential rate hike, in line with street estimates, but the odds of a September hike have started to rise.

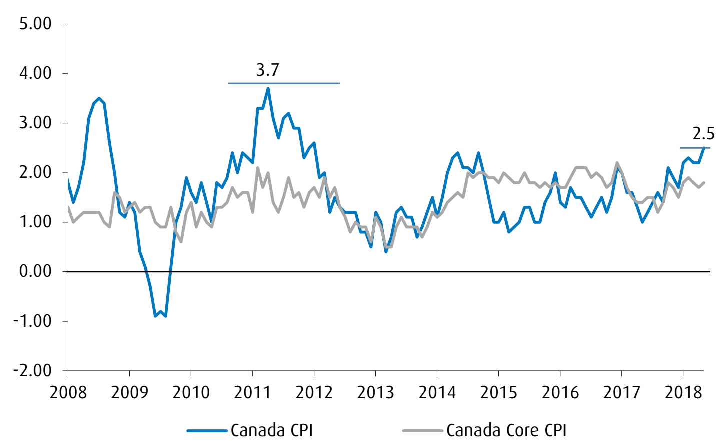
Inflation has been rising, supporting higher interest rates. Only a year ago, the Canadian Consumer Price Index (CPI) was bottoming at 1% before reaching 2.5% in June, rising at a faster pace than interest rates. As a result, Canada short-term real rates (nominal rates stripped of the inflation component) have remained in negative territory. This is still a very stimulative environment considering the strength of the economy and supporting the notion that the BoC's re-normalization work is not over. But this begs the question as to why rates still do not reflect the general positive tone about the economy and the bullish equity narrative?

Figure 1: Monthly Canadian Gross Domestic Product (GDP)



Source: Bloomberg

Figure 2: Canada Consumer Price Index (CPI) and Core CPI

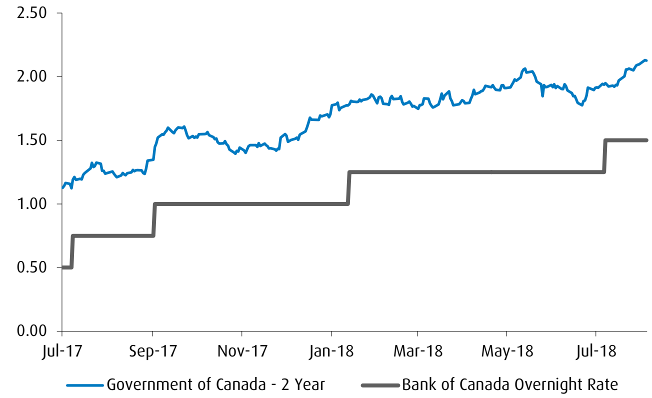


Source: Bloomberg

The BoC's gradual approach to its monetary policy adjustments help explain short-term negative real rates as the central bank tries to slow the ascent and limit negative impact. However the Bank's actions have had less of an impact on long term rates which remain low by historical standards. In today's markets, not only do bond investors get limited compensation to extend term and no risk premium, but interest rates fail to reflect an economy that has been growing above 2% since 2017 nor wage growth and inflation that have been accelerating as of late.

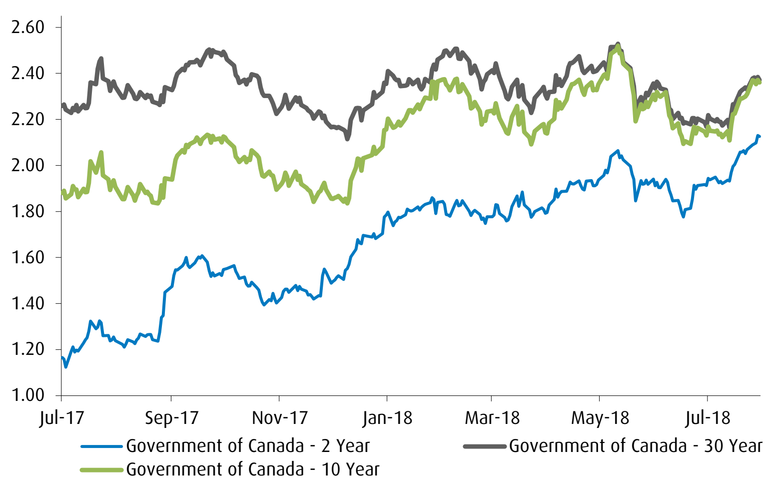
Yields did rise since the BoC began tightening but not as much or as fast as initially anticipated. Since July 2017, the Canadian 2-year yield added approximately 90 - 100 basis points (bps) or 1.00%, practically matching the BoC's four rate hikes but leaving little room for further tightening expectations. As for the Canadian 10-year yield sector, it has risen by 40 to 45 bps and worse, the 30-year yield has risen by less than 25 bps despite the CPI more than doubling over the period. This has led the Canadian yield curve to flatten significantly over the same period. As a result, investors today would earn only approximately 25 bps (0.25%) more to invest in a 30-year Canada bond instead of a 2-year bond. This leaves very limited compensation for the risk the economy could face during these extra 28 years, in particular inflation!

Figure 3: Bank of Canada Overnight Rate and Government of Canada 2-Year Yield



Source: Bloomberg

Figure 4: Government of Canada 2-, 10- and 30-Year Interest Rates



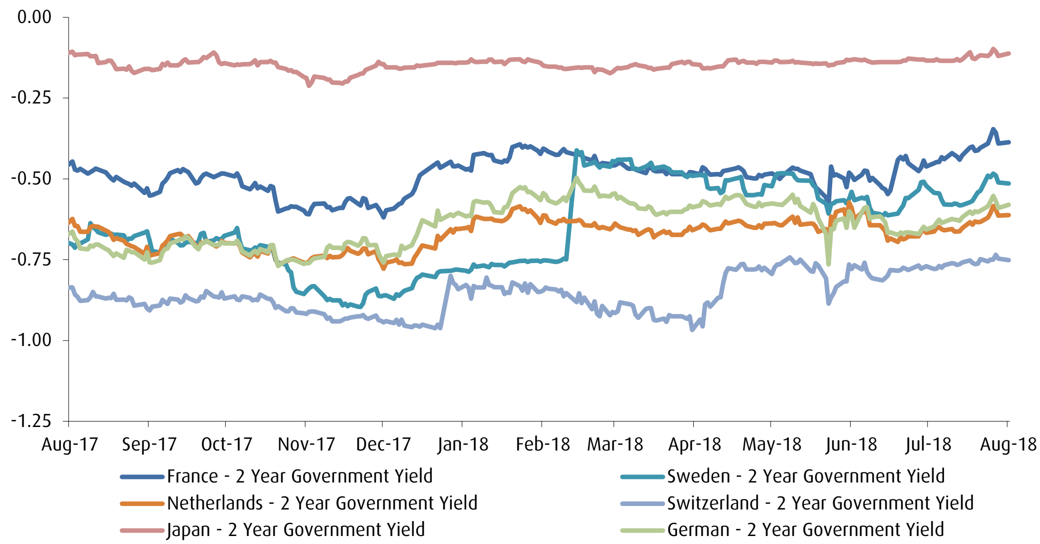
Source: Bloomberg

There have been numerous forecasts for higher rates but with the exception of short-term rates, they have yet to materialize. From a fundamental perspective, rates should be higher but we need to realize that today's market environment is different than the past and many new domestic and global factors are now more predominant in explaining the current state of interest rate markets. Over the last 12 months, despite the general rise and the run higher, the Government of Canada 10 year yield has not been able to re-test this year's high of 2.52%, while the U.S. 10-year Treasury can't seem to find strong footing above the proverbial 3%, despite not only the strong economy and inflation but also the increased supply of Treasury securities.

Central banks bear a lot of the responsibility for the persistent low rates. Over the last 10 years, major central banks have provided extraordinary monetary stimulus, which will still take years to remove from our economies. The Fed's and the Bank of Canada tightening policy may have helped interest rates move from historical lows, but their gradual approach to tightening has reduced the risk of shocks to fixed income markets and lowered the volatility.

The same can be said for other major central banks led by the European Central Bank (ECB), the Bank of Japan (BoJ) and the Bank of England (BoE). While the latter just raised rates, their policies remain very accommodative; both the ECB and BOJ continue to purchase assets and both have confirmed their intention to maintain a very low rate policy. This is forcing investors to not only increase term and risks but also to diversify geographically. Let's not forget that there are still 8 major countries with negative 2-year government nominal yields, as shown in Figure 5. This has certainly contributed to increased demand for Canadian and U.S. fixed income products, something we have noticed over the last 2 years.

Figure 5: Selected Countries with Negative 2-Year Nominal Interest Rates



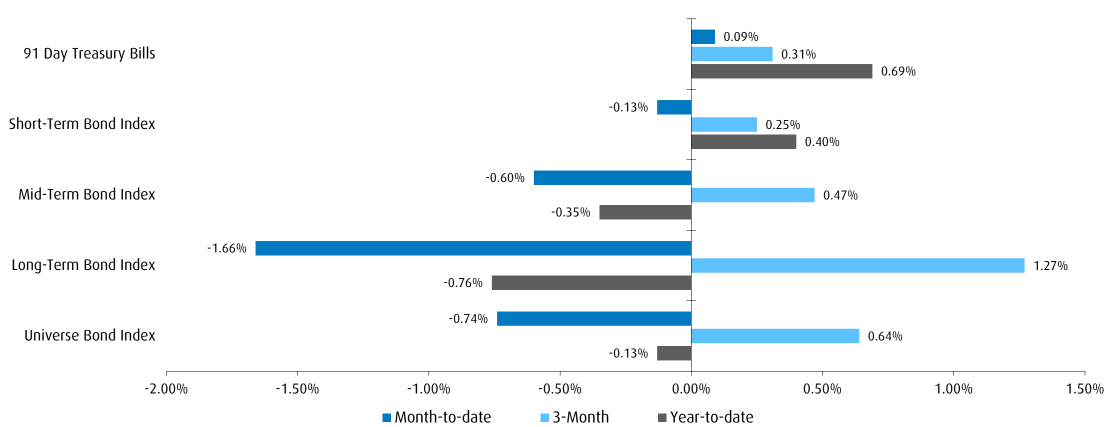
Source: Bloomberg

From a global perspective, we are approaching the U.S. mid-term election with early indication that Trump's Republican party could lose its majority status and we question whether the U.S. tax cuts can provide an additional thrust to an economic expansion that is already considered long by historical standards. We can also add to the mix the unsuccessful and dragging Brexit negotiations with less than a year left before the separation that could have a significant impact.

We are not even addressing the growing impact demographic forces are having on investments as the aging population seeks safer returns, increasing global demands for fixed income securities. This trend is expected to continue to grow and is likely contributing to flatter global yield curves.

So while some remain puzzled as to the muted response to better economic fundamentals, today's environment of active central banks, demographics, globalization and increased market correlation is likely distorting traditional forecasting of interest rates. The economy is stronger and inflation is rising; both of which should lead to higher rates gradually, at least short term rates!

Figure 6: FTSE TMX Universe Bond Index Returns (for the period ended July 31, 2018)



Source: FTSE

General Disclosure