Portfolio Advisory Team

Portfolio Management

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Fixed Income Strategy

2019 Interest Rate Forecasts

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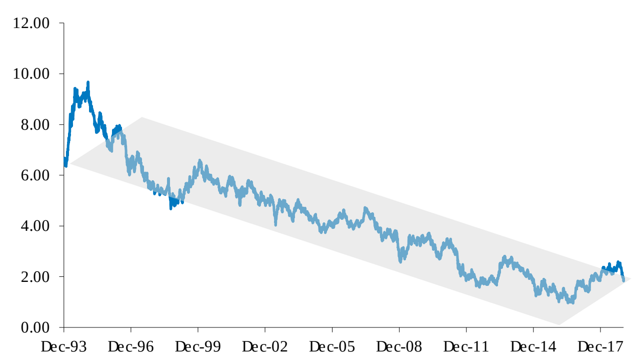
After a rocky start, fixed income markets recovered late in the year to help post positive returns at a time when the outlook for riskier assets deteriorated. In a year marked by greater political uncertainty and higher volatility the best returns were delivered by shorter-term investments as investors reduced not only term exposure but also credit exposure.

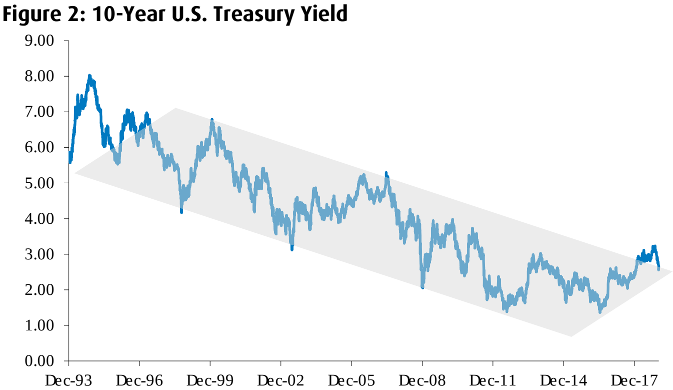
The combination of Central Bank tightening, stronger economic growth, and renewed inflation were seen as major catalysts in 2018 for higher interest rates, both domestically and globally. The expectations were for longer-term rates to finally rise above long-term technical downtrend channel marking the end of an era (the end of the bull market for interest rates) as the synchronized global economic growth story would remain in force. Worst, inflation was singled out as one of the major risks being underpriced especially at the longer end of the yield curve, causing a challenging environment for fixed income investors as limited opportunities would be available to hedge against rising interest rates.

Figure 1: 10-Year Government of Canada Yield



Source: Bloomberg

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



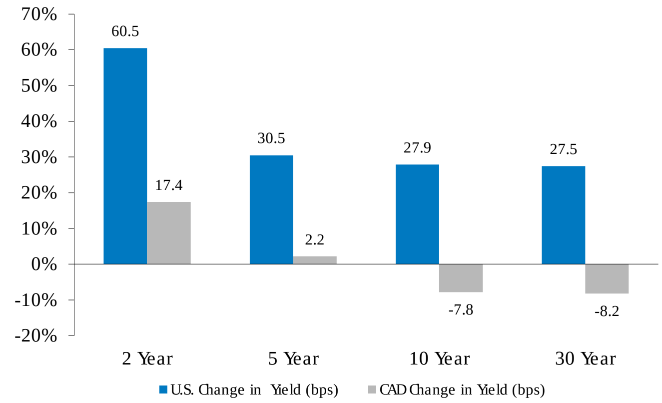
Source: Bloomberg

The story did hold for some time but the forecast failed to materialize. Economic growth was stronger but this was mainly a U.S. story as Canada, Europe and even China decelerated as the year progressed. This supported the U.S. Federal Reserve's (the "Fed") more aggressive stance on monetary policy tightening with four 25 basis points rate hikes (1.00%) in 2018 and the increase in the size of its balance sheet reduction program[1] that saw close to USD 400 billion maturing securities not being reinvested. It initially helped driving interest rates higher but markets failed to maintain these levels throughout Q4 as expectations for further interest rate hikes melted away. Concerns over trade negotiations, political uncertainty, softer economic data, Brexit negotiations and more recently, global market turbulence, led investors to believe the Fed would be less aggressive in its tightening efforts helping government bond markets recover as interest rates resumed their downtrend.

[1] During the 2018 financial crisis, the U.S. Federal Reserve significantly increased its balance sheet by purchasing substantial amounts of longer-term fixed income securities aimed at putting downward pressure on longer-term interest rates and easing overall financial conditions.

The same could not be said about Canada which experienced further economic deceleration from the 2017 cycle peak levels. Rising inflation in the first half of the year did provide support to the Bank of Canada ("BoC") tightening, albeit at a less aggressive pace than the Fed. However, the BoC adopted a more precautionary tone in December sounding less upbeat of the economy, lowering the chances of further tightening and leading bond yields lower to the end the year.

Figure 3: Annual Change in Government Bond Yields (basis points) – Canada/U.S.

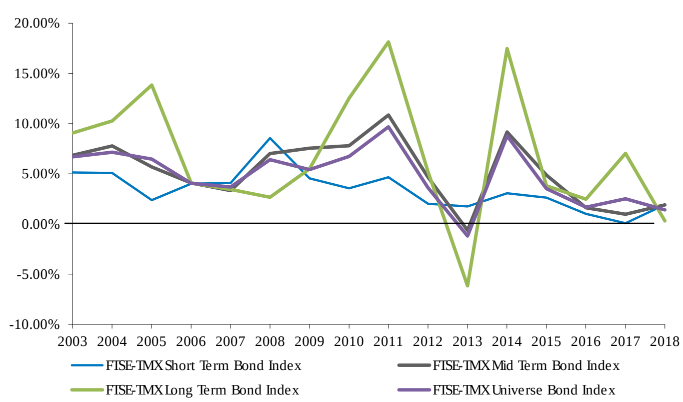


Source: Bloomberg

On average Government of Canada bond yields (see Figure 5) were flat to lower from 12 months ago with the exception of the short-term sector where rates were more directly impacted by the BoC three rate hikes (0.75%). The 10-year bonds ended just below 2%, more than 60 bps lower than the October peak of 2.61%. In the U.S., the impact of the more aggressive Fed pressured rates higher across the yield curve with the biggest rise in the shorter maturities. Interestingly, in a year where fixed income markets had to deal with stronger economies, further Fed tightening and larger U.S. treasury supply – almost tripling from 2017 levels – interest rate increases were in fact relatively muted. More importantly, 10-year Treasury yields failed to confirm a definitive break above the symbolic 3%, ending the year at 2.68% after testing 3.25% earlier in Q4.

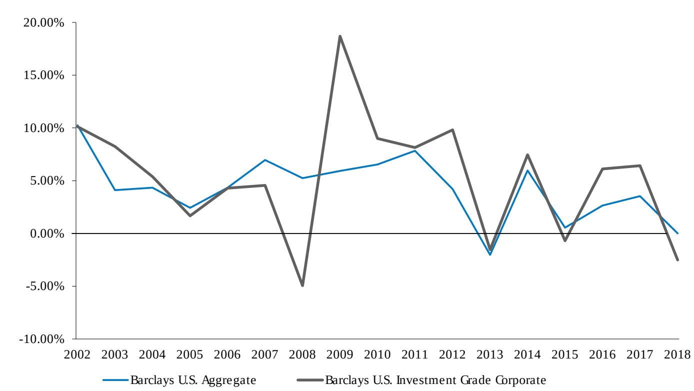
Overall, the Canadian fixed income market outperformed the U.S. (See Figures 4 and 5), but for many investors this may not be reflected in individual portfolio performances for three main reasons: a focus on shorter investment solutions, floating rate investment vehicles and overweight corporate allocation. First, with the prospects of rising interest rates and volatility investors focused on reducing their portfolio's term exposure or interest rate sensitivity. While this strategy proved beneficial in the earlier quarters, shorter portfolios failed to participate fully in the year-end rally. Second, floating rate investment vehicles provided a natural edge to central bank tightening but have underperformed in Q4 as both the BoC and the Fed adopted a more dovish tone. Lastly, corporate bonds significantly underperformed government securities as investors, in general, reduced exposure to risky assets, causing corporate bond yield spreads to widen as governement yields moved lower, limiting the participation of the sector to the recent price appreciation.

Figure 4: FTSE-TMX Universe Bond Indices Total Returns (Annual)



Source: FTSE-TMX

Figure 5: Barclays U.S. Aggregate Bond Indices Total Returns (Annual)



Source: Barclays

So what do we have to watch for in 2019? With no surprise, U.S. politics will continue to capture our attention with the government shutdown, debt ceiling and trade negotiations. The shift in the balance of power in Washington in January as the Democrats take control of Congress will definitely change the landscape and may help soften Trump's rhetoric. Labour markets are expected to remain strong and continue to support healthy wage gains for the time being, helping to extend the duration of the current cycle. However, recent softness of the economic data plus the natural lag between monetary tightening and its economic impact may allow the Fed to be more patient and flexible, potentially slowing down the pace of tightening. While a pause was not specifically mentioned, recent commentaries from Fed Chairman Powell prompted downward revisions to next year's tightening expectations from three rate hikes to one or two. Markets are less optimistic, as current valuations no longer price the probability of a full 25 bps hike over the next 12 months.

In Canada, the weakness in the Energy sector is likely to have a more material impact on the economy and continue to pressure inflation lower. Real growth is expected, at least for the first quarter, to remain sub 2% while inflation should continue to trend below the BoC's 2% target. If we also consider the negative impact of higher short-term interest rates on real estate and consumer loan growth in the context of limited wages gains, this will likely translate in a more benign interest rate environment that will lead the BoC to be more patient. In addition, the revised historical GDP data has led the BoC to believe the economy may have further spare capacity than originally expected before economic growth becomes inflationary. This re-inforces the notion that there is no urgency for the BoC to raise policy rates, and significantly reduces the chances of a rate hike in the first quarters of 2019.

Interest Rate Forecasts and Total Return Expectations

The balance of risks should provide support for fixed income markets to generate positive returns in the first half of 2019, but like the past couple of years, we recommend investors keep expectations low. What should help performance is the fact that inflation remains low and the risk of further tightening from not only the BoC and the Fed but all major central banks is significantly lower compared to the end of 2017. The reduced probability of rising rates should help mitigate the risks of bond prices depreciating. Furthermore, after a year of rising interest rates for both corporate bonds and Guaranteed Investment Certificate ("GICs"), investors should start to benefit from a greater source of portfolio income. Also, compared to 2017, we believe that corporate bonds may not yet offer appropriate compensation normally required if we assume further economic slowdown, even despite the recent underperformance of credit markets in general. While we remain constructive on short-term corporate bonds, we would caution against going on a buying spree and instead would recommend not only selectiveness but maintaining a strong quality bias. We are also reiterating our recommendation to avoid the non-investment grade sector (securities with a credit rating below BBB-) and limit exposure to BBB issuers.

In terms of the appropriate interest rate sensitivity for portfolio, we recommend to gradually move duration above 4.00 years toward neutral compare to our preferred benchmark (50% FTSE short-index Index/ 50% FTSE mid-term Index) which had a duration of 4.61 years at the end of December. For comparison, a 5- and 10-year Government of Canada bond carries a duration of approximately 4.50 years and 8.9 years, respectively. While the risks remain tilted toward higher rates that would negatively impact performance, we do not believe this to be imminent.

Figure 6 provides a sample of BMO Economics' interest rate forecasts for the next year. Taking a closer look at these forecasts, we find that they reflect some risks of rising interest rates, but still remain within manageable ranges. Interestingly, BMO Economics does not expect the U.S. 10-year Treasury yield to close above 3% before the end of 2019, a level many believe would be a signal of the end of the long bond bull market. This would mark the end of a consolidation period and bottoming process that started in 2011.

Figure 6: BMO Economics Interest Rate Forecasts

	Actual	Forecasts									
	2018	2019							2019		2020
	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Q3	Q4	Q1
Cdn. Yield Curve											
Overnight	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.00	2.25	2.25
1 year	1.88	1.85	1.90	1.90	1.95	2.00	2.00	2.10	2.15	2.25	2.30
2 year	1.86	1.90	1.90	1.95	1.95	2.00	2.00	2.10	2.10	2.20	2.25
5 year	1.89	1.90	1.95	1.95	1.95	2.00	2.05	2.10	2.10	2.20	2.25
10 year	1.98	1.95	2.00	2.00	2.00	2.05	2.10	2.15	2.15	2.20	2.25
30 year	2.18	2.15	2.20	2.20	2.25	2.25	2.30	2.35	2.35	2.45	2.50
U.S. Yield Curve											
Fed funds	2.38	2.38	2.38	2.38	2.38	0.00	2.63	2.63	2.63	2.88	2.88
3 month	2.35	2.45	2.45	2.45	2.55	2.65	2.70	2.70	2.70	2.90	2.95
1 year	2.60	2.60	2.60	2.65	2.75	2.80	2.85	2.85	2.90	3.05	3.05
2 year	2.49	2.55	2.55	2.60	2.60	2.65	2.75	2.75	2.75	2.85	2.95
5 year	2.51	2.55	2.60	2.60	2.65	2.65	2.75	2.75	2.80	2.90	2.95
10 year	2.68	2.70	2.75	2.75	2.75	2.80	2.85	2.85	2.90	2.95	3.00
30 year	3.01	3.00	3.05	3.05	3.05	3.10	3.15	3.15	3.20	3.25	3.25
Other G7 Yields											
10yr Bund	0.24	0.25	0.30	0.30	0.30	0.35	0.35	0.35	0.40	0.45	0.45
10yr Gilt	1.27	1.30	1.30	1.30	1.30	1.35	1.35	1.35	1.35	1.40	1.40
10yr JGB	0.00	0.01	0.01	0.02	0.02	0.02	0.03	0.03	0.04	0.05	0.05

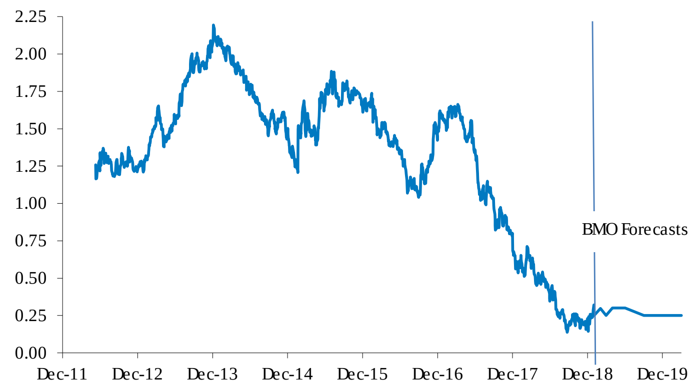
Source: BMO CM Economics

In summary, BMO Economics expects 10-year U.S. Treasuries to rise by the end of 2019 to 3.05%, as compared to last year's call of 2.75%. For 10-year Government of Canada bonds, the yield is expected to rise by 38 bps to 2.35%. While these higher interest rate forecasts are BMO's base case scenario, we believe there are at least two other potential outcomes that should be considered. First, we would not be surprised to see interest rates not only staying low for a bit longer than expected, but also moving lower. Second, a benign inflation environment combined with significantly deteriorating domestic and global economic landscapes could lead North American yield curves to flatten further and potentially invert. As we said before, this should not be construed as a confirmation of an upcoming recession but it would definitely be a symptom of a much weaker economic environment.

Figure 7: U.S. 2-30 Year Yield Curve (Yield Differential)

Source: Bloomberg, BMO CM Economics

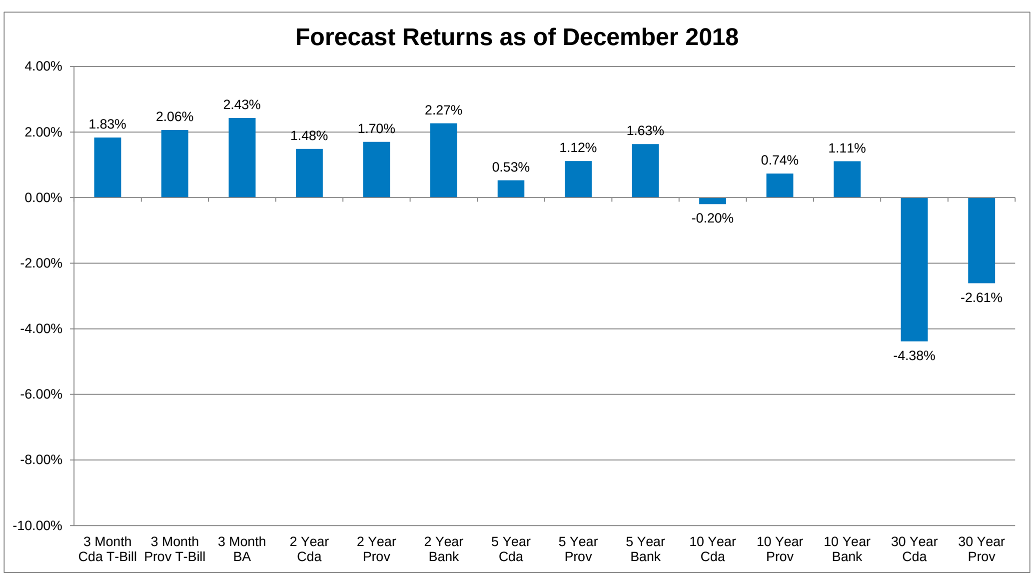
Figure 8: Canada 2-30 Year Yield Curve (Yield Differential)



Source: Bloomberg, BMO CM Economics

Using the 2019 BMO forecasts for Canada, we calculated the expected total returns for selected government and corporate bonds over the next 12 months, assuming that these forecasts are realized. Lower interest rates would contribute to greater price appreciation in the short term and be beneficial to portfolio performance. However, investors should understand that lower rates could also reflect a more challenging environment for corporate credits, thus reinforcing our recommendation to focus new investment on government and better quality issuers.

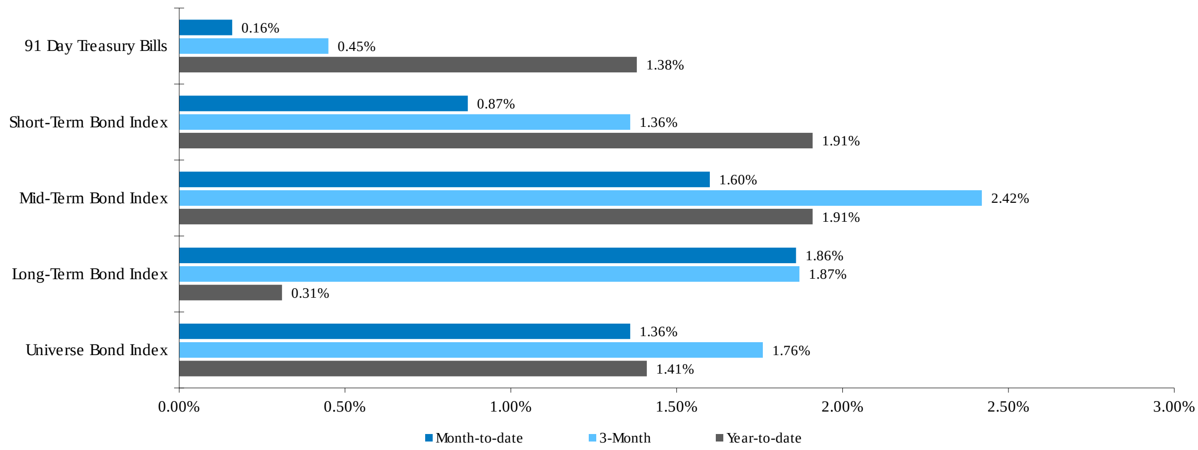
Figure 9: Total Returns for Selected Securities based on BMO Capital Markets' Interest Rate Forecast (as of December 31, 2018)



Source: BMO Economics

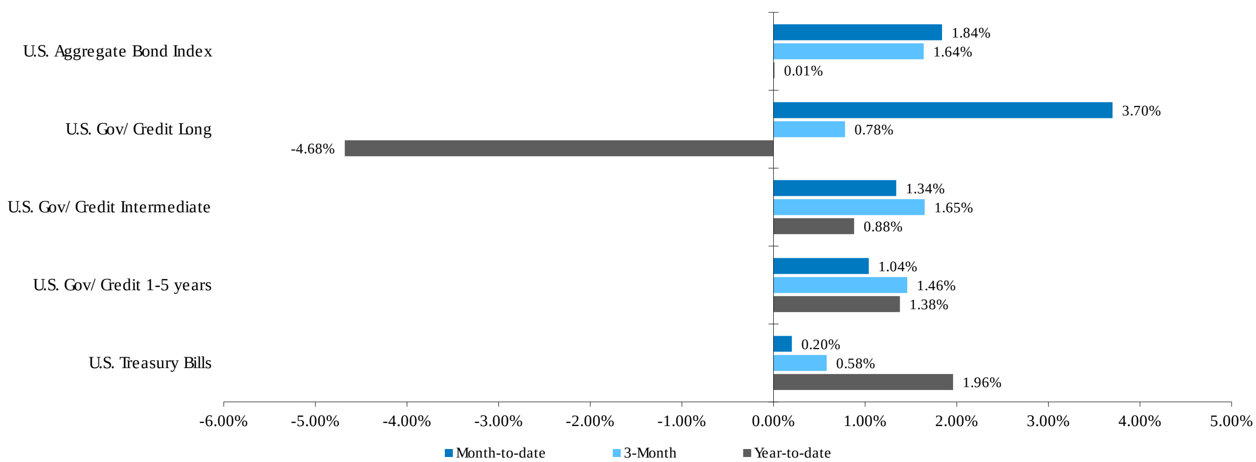
Fixed Income Market indices – Canada & US – Q4 2018

Figure 10: FTSE TMX Universe Bond Index Returns (for the period ended December 31, 2018)



Source: FTSE-TMX

Figure 11: Bloomberg Barclays U.S. Bond Index Returns (for the period ended December 31, 2018)



Source: Bloomberg Barclays

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