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Focused Fixed Income

Market Highlights

Normally, discussing the Governor of the Bank of Canada would be left to Canadians, and more specifically, those who spend their time following the bond market. You would be hard pressed to find many Canadians, old enough to remember, who know who the Governor of the Bank of Canada was before David Dodge (some may not even remember Dodge himself, except that he pops up in the press pretty regularly). It was Gord Thiessen, in case you were wondering. But times are different, and central bankers are celebrities, and Mark Carney is as big as they get. His jump to the Bank of England next summer is big news and despite assurance that it will be business as usual at the Bank of Canada, his departure may make a difference to how the Bank and its actions are perceived.

Throughout his term, Governor Carney has pushed for more transparency (as has Fed Chairman Bernanke) and communication has taken on an increasingly important role in monetary policy. The Bank's overnight rate has remained steady since September 2010, yet the markets have consistently responded to Bank communique. We believe the willingness of market participants to un-critically follow the Bank's directions will diminish with a new, less venerated governor in charge. With indications that economic growth is slowing, yet the Bank still holding steady to a policy biased to higher rates, it will be interesting to see events unfold, noting that Carney will stay on as Bank Governor until the summer. Further out, we think it likely that markets take the lead on setting the path of short-term yields.

With the election over, it took little time for the *Fiscal Cliff* to dominate sentiment in capital markets. The uncertainty that the *Fiscal Cliff* presents has upset the demand for risky assets – corporate bonds included, particularly high yield. Of longer term consequence, business sentiment has also been disturbed; delaying capital investment, while hurting employment in the process.

It has become tough for investors to correctly gauge appropriate levels for asset prices, given the amount of policy uncertainty that has become a reality since the credit crisis. Governments have generally turned away from stimulus, having been forced either internally or externally to deal with their troublesome deficits. Central banks have stepped in, *ballooning* their balance sheets, in an effort to prevent economies from stalling, and to prop up risky assets to preserve whatever wealth effect they can. Not surprisingly bond prices have been volatile, but have traded within a fairly well defined range. (For example, following the decline in yields in Q1, 10-year Canada's have traded between 1.6% and 2.2%.)

Despite the uncertainty that has plagued equities and high-yield bonds, domestic investment grade corporates have continued to attract good demand. In November we saw a total of $5.8 billion of investment grade issuance ($1.1 billion in non-investment grade) from Utility, Pipeline and Commercial Services issuers amongst others. As we have commented before, demand was deep from retail where flow into corporate bond funds was strong and equity investors added to their holdings of corporate bonds. Yield appears to still be king, as the reliability of monetary policy support trumps the uncertainty of fiscal policy restraint.

Outlook

Although the deadline for going over the fiscal cliff is fast approaching we won't go over just yet. We anticipate some kind of short term compromise, but bond investors should be prepared for more market volatility. There will likely be some kind of positive bounce to equity and credit markets, but we expect the optimism to be short-lived. As for the Fed, we fully expect it to extend its quantitative easing program to deal with the economic and market fall-out from the reality of an **unattainable** grand bargain. We will look for opportunities to capitalize on the uncertainty.

While most of the developed world has struggled since the Credit Crisis, the Canadian economy has succeeded on the back of household consumption and government spending – two areas that cannot be counted on going forward. In addition, we don't see a resurgence of the manufacturing sector on the horizon. However, according to overnight indexed swaps, only a negligible amount of investors expect the overnight rate to be lower one year out; although the number expecting a rate increase has declined. We believe the probability of a rate decrease will gradually increase, and that the Bank of Canada's next move is more likely to be lower.

We expect credit markets to continue to receive the support of central banks. Both the Fed and the ECB have put in place policies that should sustain demand for corporate bonds, despite broader policy and economic uncertainty. Corporate yields spreads have narrowed substantially from their peak of last year, but have likely run out of room to narrow further. (Today's crop of bond managers has likely not forgotten 2007, when risk was all but forgotten.) We are overweight corporate bonds, but prefer less risky issuers.

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