July 31, 2015

Focused Fixed Income

Market Highlights

The US bond market was volatile during July – much as we anticipated – whereas the Canadian bond market was more directional. Movement in the US bond market is the result of opposing investor sentiments: between those expecting the Fed to make good on its discrete, yet clear, signals that a rate hike will arrive in September; and those believing that the data behind the Fed's data dependent mantra will not allow them to move to sometime later this year, if at all. In Canada, the market was left to responding to the Bank's relatively unexpected drop in interest rates at their July 15th meeting.

US data released in July was mixed with June's retail sales being surprisingly weak indicating that consumers are still being held back by disappointing wage growth, despite much lower energy costs – consumer confidence surveys were also disappointing. However, housing data was generally positive, with new home sales the one sizable disappointment, perhaps suffering from inadequate supply. Industrial data was varied with a notable positive signal coming from an increase in capital equipment orders.

Although the Fed has indicated their preference for data dependency, it appears that they have moved from a position of the data having to force them into action to a position of the data having to force them out of action. We believe the Fed has given a clearer indication of its intended course in its most recent policy statement: *The Committee anticipates that it will be appropriate to raise the target range for the federal funds rate when it has seen some further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term.* The Fed has previously stated that they are confident that inflation will move up, while seeming to have just lowered the bar for the labour market to only "some further improvement". In our opinion, June's data was not clearly directional, thus leaving the Fed on course for an increase in September, barring an unforeseen large drop in payrolls.

The Canadian economy was unfortunately, "not so mixed", thus giving the Bank of Canada cause to surprise investors with a second reduction of overnight rates this year. While there have been some signs of consumer activity – notably the housing market is still active in parts of the country, the trade sector has not shown adequate signs of improvement. Thus Governor Poloz has taken it upon the Bank to further depreciate the Looney and stimulate trade. One could argue that a hike by the Fed will likely lean on $/CAD further, but clearly the Bank was not prepared to wait on what is still not a guaranteed move.

During the month, US 2-year yields rose by 4 basis points while 10-year yields fell by 13 bps, accounting for some skepticism about the imminence of the Fed's one or more increases. In Canada, with July's Bank cut, and another partially priced in, Canada 2 and 10-year yields fell by 8 and 25 bps respectively. The spread between US and Canada 10-year yields has now opened up to 77 bps, twice the amount at the beginning of the year and close to the historical wide of 82 bps seen in February.

The corporate market also felt the heat of uncertainty over the economy and monetary policy. Corporate investors appear less willing to take on more credit risk, particularly after such a long period of relatively stable overnight rates in both Canada (until January) and the US. Yield spreads widened by average of seven basis points across the sector with the poorest performance coming from the higher beta (more volatile) issuers. Reduced liquidity continued to be a problem for the corporate market with secondary market activity limited, consequently hurting the performance of new issues.

Outlook & Strategy

We believe the Fed is fully on track for a September rate hike and will only be deterred if August's employment report surprises significantly on the downside. We don't believe there is sufficient volatility in the inflation numbers, for them to make a difference either. As for the Bank of Canada, we expect it will sit on the sidelines ahead of the Federal election, and wait for the Fed's September hike – the C$ should weaken in the process. However, we recognize that the Bank has been inclined, of late, to surprise investors, and therefore place some probability of a September hike should the trade data disappoint further.

Both the US and Canadian yield curves flattened in July, but we expect this move to reverse in August, with the move in the US likely to be more substantial than in Canada. It is possible that both US-Canada 10 and 30-year yields spreads will reach historically wide levels in the process. We believe a rise in longer term Canadian yields and a steepening yield curve still justifies a shorter duration positioning with an overweight in the middle of the yield curve. At today's yield levels, there is not much protection for longer term bonds for any rise in yields.

Corporate spread levels currently represent more than half of all-in-yields and thus provide good relative value and relatively good protection against yield spread widening. The portfolio is structured conservatively, possesses good liquidity, and therefore is well positioned to capitalize on relative value and yield enhancement opportunities.

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