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Focused Fixed Income

Market Highlights

Bond markets were relatively tranquil in August with no jarring numbers or big events to move yields and yield spreads. However, hidden amongst all the data points and news clips was a subtle shift that we feel has been gaining momentum amongst central bankers, and more recently and most importantly the Fed, which we think is likely laying out a roadmap for monetary policy. This shift in Fed thinking was most apparent at the Fed's annual Economic Symposium and confab at Jackson Hole, Wyoming hosted by the Federal Reserve Bank of Kansas City at the end of August where the title of the symposium was *Designing Resilient Monetary Policy Frameworks for the Future* with two of the five formal topics of discussion: *Adapting to Changes in the Financial Market Landscape and Negative Nominal Interest Rates*.

Looking at the content of the Jackson Hole symposium (www.kansascityfed.org/publications/research/escp/symposiums/escp-2016) and reading remarks from Fed members, it becomes pretty apparent to us that the Fed has moved past its obsession with normalizing interest rates to some nebulous historical average to preparing its "toolbox" for the next recession, while searching for some novel rationale for why interest rates should be maintained at a much lower level. It appears that the Fed will not rule out "Negative Nominal Rates" (or NIRP) from its toolbox, nor is there a guarantee that it will ever be used. As for why the Fed will go at a glacial pace to raise rates to a much reduced threshold, higher inflation targets, historical growth anomalies during the Volcker-Greenspan years and reduced future productivity gains (amongst other reasons) have all been suggested.

Unfortunately for those still fixated on the Fed's dot plots or the need for higher rates (to aid struggling savers), August data was mixed enough to give Janet Yellen yet another out for avoiding a fall rate hike. The employment report was insufficient to force a move – not entirely weak – with 151,000 in new jobs and 20,000 upward revisions to both of the two prior months – but with higher unemployment. Both ISM manufacturing and service reports were definitely weak, suggesting problems for businesses. Consumer spending continued to be a bright spot, with strong retail and auto sales, clearly benefitting from borrowing rates and lower energy costs.

The Canadian economy finally provided some reason for hope with an improvement in the trade balance of about C$1.5 billion from June to July with across the board gains, most notably from automobile shipments. Unfortunately second quarter GDP was reported at -1.6% annualized, indicative of the ground the Canadian economy needs to make up from low energy prices and the hit from the fires in Fort McMurray. Despite the weak economic fundamentals, the Bank of Canada governor Poloz maintained a very low profile throughout the summer, electing to allow fiscal policy and the "apparent" US-Canada monetary policy divergence to play out.

Elsewhere, economic growth was also challenging with two of the biggest European economies – Italy and France struggling, and Germany also lackluster. As a whole the Eurozone demonstrated a need for continued central bank support which the ECB has been happy to provide. Unfortunately for financial institutions, pension funds and regular old savers, over US $4 Trillion of European sovereign debt yields are now below zero (Fitch) and corporate bonds are becoming scarce. So far, the Brexit disaster has failed to materialize, with the UK economy being supported by aggressive action from the Bank of England.

Outlook & Strategy

We are not expecting any imminent movement from neither the Fed nor the Bank of Canada. The Fed is constrained not only by underlying economic data and uncertainty emanating from foreign markets and policies, but perhaps more importantly its inability to temper investor proactivity to genuine rate increase signals. The Bank of Canada will be content to watch fiscal policy unfold and look for some bounce on the back of a rebuild in Fort McMurray.

The long ends of the Canadian and US yield curves have already had significant responses to declining rate structures in Europe and Japan. We expect the yields to continue to be volatile, but do not expect to see further sustained declines. Although North American economies have slowed, there are still significant areas that should sustain reasonable levels of economic growth and inflation.

We will maintain a relatively shorter duration with an overweight in corporate bonds and look for relative value and trading opportunities.

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