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Focused Fixed Income

Market Highlights

The capital markets have started the year in disarray. It seems that weak oil prices and the global knock-on effects are at the heart of what troubles the market. But Central Bankers have been central to capital market behaviour for some time, why should 2016 be different? Yes, the oil sector has received tons of easily available investment since the credit crisis and there is now a glut of supply; there are lots of oil exporters in the world dependent upon high oil prices (Canada included) and they buy things from goods exporters such as China. But there are also lots of oil importers who are benefitting, and will continue to benefit, from cheap oil (China included). The Fed ended last year with a rate hike and a message of more to come, the ECB with indications of more bond buying, and the Bank of Canada with a proclivity for non-traditional stimulus. So, as the capital markets bump around in the first quarter, it makes sense to pay attention to oil, but it is equally, if not more, important to understand the impact of low rate policies and how central banks are likely to behave going forward.

Low oil prices should be seen mostly as a realignment of the distribution of wealth between producers and consumers of oil. However, and this is a large however, to the extent that producers reinvest their income, transferring money from producers to consumers can be less productive if consumers are not deploying those transfers through consumption or investment. In a global context, the effect of shifting wealth between producers and consumers is varied. Certainly, moving money from fast-growth developing countries to slow-growth developed countries is likely to be negative in the short run but more money in consumer's pockets will eventually raise slower growth rates. In addition, some oil exporters are either relatively slow-growers or not necessarily significant on a global GDP basis. The matter of investment is more complicated as, depending upon the exporter, profits will be directed back into a mix of related industry capital spending, government programs, or foreign investment opportunities.

The data in the US suggests that, in the short-run, US consumers are mostly paying down debt with their petro-savings. Also complicating the US situation is the US's role as a fast growing, capital, and technology intensive producer (not yet a net exporter) of oil. So in the US context, higher oil prices, has precipitated a reduction of investment and production that had previously had a significant impact on domestic growth, and which has not been offset by consumer spending or investment. But, as has historically been the case, putting more money in the consumer's hands will eventually reach the domestic economy and boost growth.

The Fed began turning off the monetary taps over a year ago with the limitation of QE to reinvestment of coupons and maturities. But last year's December rate hike began a policy reversal in earnest. Leading up to the hike, there was lots of market volatility, but with the first hike, the volatility has only increased. The appreciation of risk assets was clearly one of the by-products of Fed and other central banks' easy policies; hence, the depreciation has to be seen as (although not solely) a by-product of tighter policy. However, following the credit crisis, part of the objective of central bank policy was to inflate asset prices (and create a wealth effect), whereas today the opposite outcome – to deflate asset prices - is not an objective of tighter Fed policy. This leaves the Fed, as well as other central bankers, in a precarious position, and obviously one that is not easily dealt with on a global scale.

For the time being, the US economy is still generating new jobs at a healthy pace. However, US growth is facing immediate challenges from the slowdown in the energy sector, weaker global growth, and capital market losses. Bond market moves in January reflect pessimism surrounding the current economic situation, with US and Canadian government yields falling by an average of 32 and 11 basis points respectively (Bloomberg Sovereign indices). At the same time, corporate yield spreads have widened, as the ill effects of lower energy prices on parts of the high yield sector have contaminated higher quality credits. Poor liquidity, particularly in weaker credits and longer maturities has aggravated the situation.

Outlook & Strategy

In the short run, we expect weaker US growth, coupled with aggressive monetary stimulus in Japan and Europe, to drive the US yield curve. However, we think that yields are priced for weaker growth than what is likely to unfold in H1. Over the last couple of years, growth in Q1 was disappointing, marred by extremely cold winter weather – not a factor this year. More importantly we expect the energy dividend together with nascent wage pressures to gradually emerge. As for monetary policy, we expect the Fed to disappoint investors, with more rate hikes than the US yield curve is priced for – currently around a 50% chance of a hike over the next twelve months according to Fed Fund futures. We cannot imagine that the FOMC did not anticipate weak and volatile markets in response to higher rates and therefore don't expect them to retreat entirely from their plans. Canadian economic fundamentals are weaker those of the US, but this is already priced in, with longer term Canadian government yields well below those in the US. As Canadian bonds underperformed in January's rally, we would expect them to outperform in an eventual reversal. Credit spreads widened in January, as contagion from weaker industries continue to spread through the market. However, we are still confident on credit fundamentals for most domestic issuers and are comfortable that any further spread widening will be contained within break-evens, particularly for higher quality short term issues.

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