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Focused Fixed Income

Market Highlights

Janet Yellen and her partners on the FOMC spent the latter part of May trying to convince investors that they were mispricing the probability of a summertime rate hike. They were eventually rewarded for their efforts by investors, who increased their expectations of a June rate hike from 12% to 24% over the month and of a July hike from 26% to 53% (Bloomberg). However, following the just-released May employment report which revealed the worst monthly job gain since September 2010, these sentiments were summarily dismissed – probabilities for a rate hike are now back to 12% and 24% for June and July, respectively. The Fed has been trying to loosely keep to its ambiguous plan of gradual rate increases, which had led many, including us, to interpret as two hikes this year. Although, one data release does not make a trend, the 3-month average of non-farm payrolls now stands at 116,000, nearly half the 222,000 average over the prior 12 months, which will make implementing two hikes, while possible, more challenging.

Apart from employment, US economic data has been fairly uneven. Retail sales data finally improved in April (after disappointing in Q1), although much “retailers” data did not (the impact of online shopping on traditional retailers is becoming increasingly evident). Housing data released in May was also good with starts, permits, and sales all strong; albeit following mixed data for the first part of the year. Manufacturing data has also been mixed with the widely followed ISM data rebounding in May, amidst a bunch of much weaker regional reports. Issues of global weakness and stronger dollar support the notion that the contribution from manufacturing to the economy will be disappointing. Perhaps most disappointing was the ISM non-manufacturing data which showed a decline and could be indicative of weaker growth ahead.

The state of the Canadian economy is unfortunately not as mixed as the US’s, with the Fort McMurray wildfire only adding to an already challenging set of circumstances. There is no need to rehash the difficulty that the economy is experiencing, adjusting to lower energy prices and a weaker Canadian dollar. However, with the addition of the lost production due to fires, it is conceivable that we will see no real growth in Q2. The Bank of Canada had already outlined its position at the last MPR, but that was before Fort McMurray; nevertheless there is significant fiscal stimulus in the pipeline that needs to somewhat playout before the bank considers another policy move.

The insatiable appetites of Central Banks for bonds and the preference for negative rates continued to have an impact on global bond yields in May. The Bank of Japan maintained its program of corporate bond purchases during the month and the ECB confirmed it would commence corporate purchases in June. European yields fell again in May with 10-year Bund yields dropping by half to 14 bps at the end of May and by another half to 7 bps at time of writing. 10-year JGB’s remained at around -8 bps during the month.

10-Year Treasury yields finished the month of May at 1.85% just below where they started the month. Although the premium offered by Treasury yields versus European and Japanese yields is once again attracting demand, expectations that the Fed would raise rates in June, kept longer yields from falling in May. However, weaker data at the beginning of June seems to have quashed these expectations, and precipitated lower yields in the near term. Canadian 10-year yields fell by almost 20 bps to 1.32% during May, largely on the back of weaker data and the impact of the Fort McMurray wildfire.

Outlook & Strategy

As we had stated in previous commentaries, we do not expect the Fed to aggressively raise rates this year, however we believe they will struggle to get two increases in. We expect the Fed to maintain the rhetoric that factors are largely in place for them to raise rates and that they are data dependent – this should precipitate more volatility. However, the most recent employment trends will likely give the Fed reason to proceed very cautiously, with Europe providing additional fodder. Further out the presidential election could easily interfere with the timing of additional rate increases. Closer to home, we expect the Bank of Canada to wait before venturing ever closer to alternative monetary policy measures.

The Canadian yield curve has flattened so far this year as longer term yields have moved lower along with global longer term yields. We don’t expect the status quo to remain indefinitely and still anticipate steepening of the Canadian curve consistent with limited US rate hikes. We will still look for opportunities to take advantage of yield and yield curve volatility.

In the corporate market, yield spreads represent over sixty percent of absolute yields and therefore provide good relative value. The corporate portion of the portfolio is structured conservatively, possesses good liquidity and is therefore well positioned to capitalize on relative value and yield enhancement opportunities.

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