August 31, 2019

Focused Fixed Income

Market Highlights

The rally in the bond market continued apace in August with long bonds hitting historic lows, amidst further flattening of the yield curve. The decline of yields on quality sovereigns, globally, put further pressure on North American yields especially in the long end. Thirty-year Canadas and US Treasuries declined to their lowest levels ever: 1.30% for Canadas on Aug. 15th and 1.95% for Treasuries on Aug. 27th. Ten-years also fell as low as 1.09% and 1.47% for Canadas and Treasuries, respectively, but had seen lower levels in 2016: 0.95% and 1.36% respectively, when Fed Funds were targeted between 0.25-0.50%. Two-year Canada and Treasury yields fell as low as 1.30% and 1.48% respectively during the month, well above their respective historical lows of 0.29% (2016) and 0.16% (2011).

While short-term yields are well below overnight rates in both Canada and the US, implying expectations of central bank easing, policy rates are a barrier to short-term yields declining further. Market expectations are for "no movement" from the Bank of Canada and two 25-basis point eases from the Federal Reserve by the end of this year; and one cut and three cuts, respectively by the middle of next year. Although investors appear confident that both the BoC and the Fed will ease over the next twelve months, their confidence is not entirely consistent with the messaging coming out of either central bank. Both banks have equivocated on the path of interest rates, generally pointing to the uncertainty surrounding international trade and deferring to "data dependency". Furthermore, to the extent that both US and Canadian economies are being largely supported by the consumer, high consumer debt levels highlight a material vulnerability.

US economic data has provided just enough evidence for both the recession and the moderate growth camps to make their cases. International trade has slumped, and US trade has turned down. US manufacturing PMI has noticeably slowed and business investment is on a long-term holding pattern. On the other hand, the consumer has continued to keep the US economy afloat. Employment growth, which is constrained by historically low unemployment, has been decent, albeit below last year's levels, yet is generating reasonable wage growth. Inflation is below target, but that is not new, but rather a consistent feature of this recovery.

Canadian economic data has been less nuanced – there is far less material supporting the weak growth story with most data releases surprising on the upside. Earlier in the year, it appeared that higher energy prices were solely responsible for any Canadian strength, but even as energy prices have moderated, the economy has been strong. Economic growth, employment growth, retail and home sales have all shown resilience. Like in the US, Canadian manufacturing and business investment are a concern, but less so in Canada, given the more convincing domestic picture.

Outlook & Strategy

We still expect the US economy to deliver reasonable growth in 2019. However, the deteriorating and unpredictable trade environment – we are not hopeful that there will be substantial progress anywhere – and consequent impact on global growth will likely necessitate the Federal Reserve's continued involvement. We think it likely that the Fed will deliver another rate hike this year or early next – their "body language" suggest they are prepared to act. Canadian growth is vulnerable to weaker exports, and the Fed's activity could combine to force the Bank of Canada also into lowering rates.

Long-term real yields should eventually expand, resulting in a steeper overall yield curve. However, negative Japanese and European sovereign yields and resulting foreign flows into North American bond markets will remain a significant factor, depressing both long-term US and Canadian real yields. Finally, we believe that tight labour markets should eventually push inflation expectations higher, but given recent experience, are hesitant to predict the timing of this move.

We feel that highly rated, liquid, short and mid-term corporates are attractive on both an absolute and relative value basis, particularly versus less defensive global credit which are vulnerable at this stage of the credit cycle. Unlike in the U.S., a profit correction should not result in widespread downgrades of BBB-rated debt to high yield as the bulk of our BBB-rated names are characterized by high leverage but stable business profiles and cash flows. With low-term premiums, we also foresee the credit curve steepening with investors being cautious to exposure of higher levered debt out the curve, particularly for those issues with limited secondary market depth. The portfolio possesses good liquidity and is structured conservatively with a significant underweight in BBB-rated debt. It is well positioned to capitalize on relative value and yield enhancement opportunities.

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