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What We Think…

THE US

US bond yields continued to trend downwards in Q3, echoing the move that characterised the first half of the year. The yield curve (2-30's) flattened as investors pared expectations of Fed easing, but re-steepened late in the quarter as investors once again exhibited conviction that the Fed would continue to pursue a path of easier monetary policy. It appears the Fed has no choice but to protect against Trumpian trade policies, while providing cover for "risk-on" strategies. Long-term yields are off their lows, but only marginally, and would easily fall should the Fed lower rates again. The US economy has weakened, but market behaviour suggests that it would only be a matter of trade détente that could avert further economic deterioration and rapidly improve sentiment. Investors have welcomed any signs of positive developments between [trade] warring factions. However, with still over a year away from the next election, the White House seems in no hurry to make a concerted move towards reconciliation, but rather has "upped the ante" and with a wider range of adversaries. It has been our belief that President Trump would not jeopardise re-election by willingly pushing the US economy into recession, and we will see this as the most likely scenario. However, as time progresses and the US finds its trade relationships deeper in a quagmire, it will be increasingly difficult to defuse the consequence of recent policies and actions, with only the Fed willing to act. We don't fault the government for wanting to right trade relationships but do wonder if the current strategy is optimal. In any event, global growth has slowed, and capital markets have had to adjust to this reality.

This time last year, it seemed to us like the Fed had more room to raise rates and bond yields were not ready to peak. What a difference a year makes? Being Canadian, we are painfully aware how important trade can be to economic growth (for some time the BoC has discretely managed the Canadian dollar so as to promote better terms of trade and encourage capital investment). The US economy is more insulated than most against trade, given the relative importance of its domestic economy, so it is better designed to withstand trade friction/war. However, with an economy that already is facing constraints due to exceedingly tight labour markets, household indebtedness and political instability, it was doubtful that slowing on the trade side would be able to go unnoticed. To be fair, there is a contingent of commentators who have warned that the Fed's tightening program was too excessive and was enough to tip the US economy into recession without the burden of deteriorating trade.

We maintain that the US economy still has underlying strength and recession is not imminent. However, without any relaxation of trade conflicts, growth will continue to rely on the consumer, which is being supported by easy monetary policy from the Fed and other central banks. And, although Fed Funds have only been lowered by 50 bps from the recent peak, borrowers are benefitting from the inverted yield curve (in part, the result of lower yields elsewhere).

Figure 1: US Unemployment versus Wages & Core Inflation

Source: Bloomberg, Bureau of Labor Statistics & Lorica Investment Counsel Inc.; September 2019

We recognize that US economic data has weakened but contend it has done so from reasonably high levels. Employment growth has slowed – inevitable given the historical low level of unemployment (see Figure 1) – but is still high enough to support consumption growth. Wage growth is reasonable, though yet to really accelerate

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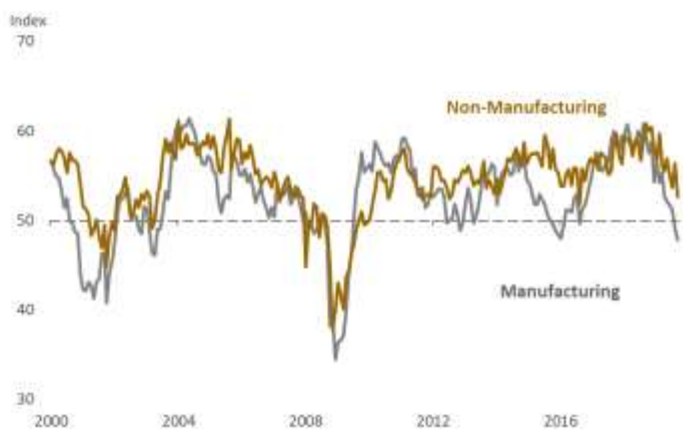
given unemployment; overall inflation is modest, but not much below target; and consumer sentiment has fallen, but from recent peaks. Admittedly, the biggest concern is business sector with both manufacturing and service ISM surveys falling significantly, albeit still well above recession territory (see Figure 2).

Figure 2: US ISM Surveys



Source: Institute for Supply Management, Bloomberg & Lorica Investment Counsel Inc.; September 2019

CANADA

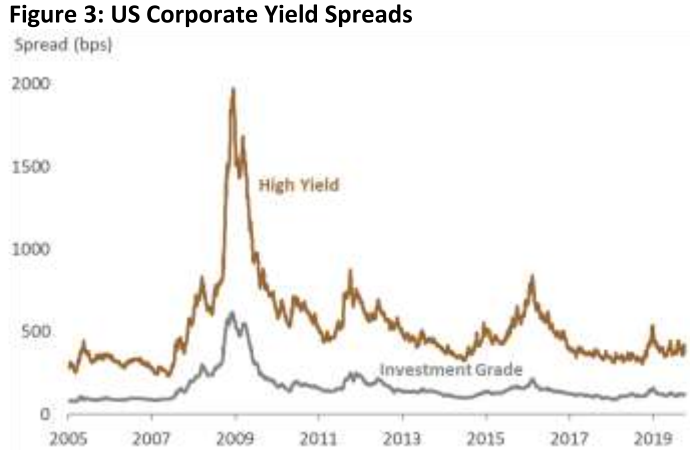
For the first half of this year the Canadian and US economies appeared to be out of sync as they traded quarters of 1% outperformance: the US leading in Q1 and then Canada in Q2. Energy prices were the biggest factor contributing to performance differentials (historically the case) with Western Canadian Select prices strengthening through Q2 before additional US supply began to come onstream. We expect Canadian and US growth to fall more into line in Q3 as energy prices become less of a factor and trade continues to emerge as the dominant issue for both economies. However, we cannot say the same for monetary policy, despite both countries facing so much trade uncertainty. While the Fed has deliberately taken a pre-emptive approach to any hints of slowing, the Bank of Canada has chosen to look through periods of economic weakness.

Markets are now pricing in only a 35% chance that the BoC will lower rates in 2019 and 85% in 2020, generally consistent with the lack of guidance from Governor Poloz. Some would point to the Canadian yield curve (2-10's) as suggesting a slow-down with the Call Loan-10-year yield curve inverted at −50 bps; although the low level of sovereign yields globally is likely contributing to the level of Canadian yields. We think it probable that the Bank will find itself lowering rates before long, given global and specific US-Canada trade uncertainties (the Trump impeachment proceedings are making it increasingly unlikely that the USMCA will be ratified), extreme consumer indebtedness, and of course, downside risks to energy prices.

REACHING FOR YIELD

With the significant decline in bond yields and market friendly behaviour by most central banks, investors once again find themselves reaching for yield. Within the bond market, the biggest beneficiary of this renewed "risk on" environment has been high yield (see Figure 3). However, we expect that investors will be increasingly less comfortable with the poor risk/reward characteristics of lower quality credits which has begun to impact high yield spreads. We also have concern for the longer end of the corporate market, which will likely see investors reduce exposure should yields continue to decline. Investment grade credits, particularly those of shorter maturities, should however offer decent performance so long as monetary policy remains supportive.

Figure 3: US Corporate Yield Spreads



Source: Bloomberg & Lorica Investment Counsel Inc.; October 2019

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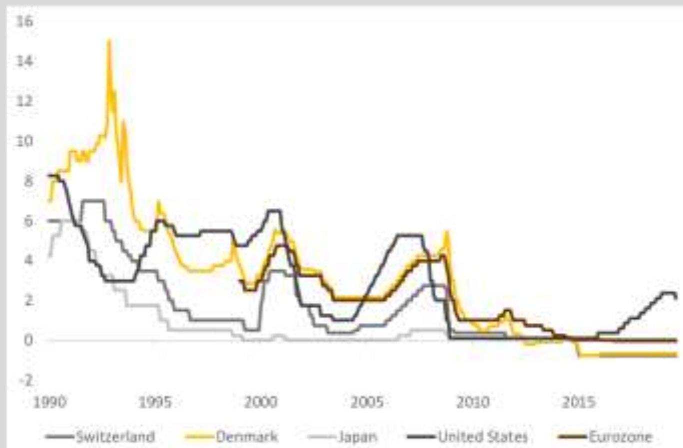
EXPLORING NEGATIVE RATES

If one were to use 10-year Treasury yields as a gauge of the bond market over the last decade, today's yields seem like déjà vu – having experienced virtually the same low levels twice in the last ten years followed by convincing back-ups of 150 bps or more. (*Are we once again going to see a similar backup?*) However, if one were to use the Treasury yield curve as a gauge, the bond market looks different – in both 2012 and 2016 when yields were this low, the slope of the 2-10's Treasury curve was over 100 bps, today it is less than zero. In both previous episodes of such low yields, Fed Funds were below 50 bps, close to the then-thought-of zero bound of policy rates. Today Fed Funds is comparatively higher at 175 bps, albeit still low in a pre-credit crisis context. Many market participants are overtly concerned about the prospects for a US recession and the Fed is feeling the pressure to exert easier monetary policy.

Proponents of the yield curve (particularly the Fed Funds-10's Treasury curve) as a recession indicator are convinced that today's inverted Treasury curve is indication of imminent recession. The FF-10's curve has accurately predicted the three last recessions with only one false (or some would say early) warning in 1998 before the 2001 recession. Similar to previous recessions, the Fed Funds rate has been rising prior to inversion – a total of 225 bps since 2015. In contrast, in 2012 & 2016 when 10-year yields were this low, rates had been more, or less steady around zero, and Quantitative Easing (QE) was in place or yet to be unwound.

The last thirty years of inverted yield curves is an interesting study in declining rates. Prior to the 1990-91 recession, Fed Funds were at 8.25%; prior to the 2001 recession at 7.25% and prior to the 2007-09 recession at 5.50%; while they are now at 1.75%. Following the "recession" inversions, Fed Funds were lowered by 525, 625 and 525 bps respectively – an average of over 550 bps. If today's Fed Funds were to be lowered by an amount equivalent to the last thirty-year average (in response to a recession) we would have Fed Funds at −3.75%, an improbable scenario. Given the narrow operating room for Fed Funds, one would expect the Fed to respond to a recession by reinstituting QE. However, with the yield curve already so flat, if long-term yields were to decline in sympathy with the drop in Fed Funds, one would have to question how much impact QE would have on lowering bond yields.

Figure 4: Select Central Bank Policy Rates



Source: Bank for International Settlements & Lorica Investment Counsel Inc.; October 2019

The lessons of some European and the Japanese bond markets are instructive with respect to the limitations of negative rates and QE. The Swiss and Danish National Banks hold top spot for lowest policy rates at −0.75% followed by the Swedish Riksbank at −0.25% with the Bank of Japan just trailing at −0.10% to round out the central banks *now* with negative rates (see Figure 4). (According to the BIS, there have been no other episodes of negative policy rates since 1946.) The central banks operating with negative rates are doing so in the context of relatively captive, and in the European cases, small bond markets, not particularly reliant on large amounts of foreign capital. Not surprisingly, policy rates create a kind of a floor for long-term rates, limited to the amount of inversion investors are willing to price-in. As at the end of September, Swiss 10-year sovereign yields were −0.76% (just 1 bp below the overnight rate) but had been at −1.12% (−36 bps below) this past August representing the lowest-ever 10-year yields. As at the end of

September, Danish 10-years were at −0.55%, 20 bps above the overnight rate. In Japan, where the policy rate moved negative in 2016 after having been 0.50% or lower since 1995, the 10-year yield was −0.22%, just 12 bps below the overnight rate as at the same date. Interestingly, 10-year Bunds have traded at −70 bps to zero ECB deposit rates.

It would appear that the BoJ does not believe that there is much policy value or even possibility of lower rates, but rather has preferred a policy of QE, which has maintained a flat yield curve. (Although one may reason that given the extent of QE by the BoJ – its Balance Sheet has expanded by just under five times since QE was first implemented in 2001 – it should have been able to lower long-term JGB yields by a greater amount.) In contrast, the ECB's QE program has managed to push a significant portion of Eurozone sovereign yields into negative territory, while maintaining overnight rates at zero. Notably, 10-year Bunds and Oats yields were at −0.57% and −0.27% bps, respectively as at September 30th. It is difficult for us to foresee a scenario where the ECB feels it advantageous to reduce overnight rates below zero; we think it more likely that it continues with its QE program, despite the controversy that has emerged amongst various political circles in Europe.

In terms of the Federal Reserve, we feel it is difficult to predict monetary policy should the Fed still be in need of easing while staring at ZIRP and a generally flat yield curve. Market expectations are currently for further rate reductions from the Fed of 25 bps in 2019 and 50 bps in 2020, but it is not obvious what would happen to long-term yields should the rates be lowered further. The Fed would be able to drop Fed Funds by 150 bps before it would hit its previous line in the sand for policy rates at 0.25%. With the downward pressure already felt in the long-end, it is not unreasonable to expect a relatively flat yield curve around zero (ten-year yields are currently 25 bps below Fed Funds). But it is difficult to know how lowering US policy rates below zero would be received, given the size, openness and foreign investment involved in the Treasury market. We think it more likely that the Fed pursues QE as a means of lowering long term yields and pushes US yields negative in the process. Whether long-term yields would be able to invert into significant negative territory as has happened in Germany is unknown.

As for the Bank of Canada, we think it more likely that a policy of negative rates would be pursued than QE if overnight rates were near zero and further easing needed to lower long-term yields. The Canadian bond market operates within a very large North American bond market (somewhat like Switzerland and Denmark in the context of the Eurozone) where the Bank of Canada's balance sheet required for a QE program could be easily overwhelmed. Hence, dropping policy rates to negative territory would have a greater likelihood of success at lowering yields, possibly into negative territory, than QE.

It was not long ago, that negative rates were thought of as impossible, today they are a reality. In our discussion we have not addressed the obvious: the broad and long-term implications of negative rates and yields. To begin, continually declining policy rates in a moderate growth and low inflationary world implies much less room for central banks to manoeuvre in future years. As the last decade has shown, it is very difficult to normalise rates when the greatest motivation to normalise rates is *to normalise rates*, when there is no accepted level of *normalised rates*, and when economic and political uncertainty gets in the way. There are also a host of investor-related concerns from negative yields on short-term funds and negative returns on bond funds, to the imprudent reach for yield through more risk. Negative yielding assets are generally owned by investors who have no reasonable alternative – should yields fall negative in more markets, more of these alternatives will disappear. Investors have already shown an inclination for taking more risk, albeit as long as central banks have been willing to insure against some of the downside, but can this trend continue?