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What We Think……

WTI

"However, the Committee believed that the softness in economic activity was caused importantly by higher prices of imported oil..." Monetary Policy Report submitted to the Congress on February 16, 2005.

"Higher energy prices last year continued to siphon off household purchasing power …" Monetary Policy Report submitted to the Congress on February 15, 2006.

"… and consumers' purchasing power has been sapped by sharply higher energy prices." Monetary Policy Report submitted to the Congress on February 27, 2008.

The last time oil prices were at today's levels, excluding the depths of the *Credit Crisis,* was in 2004-5, at the beginning of a 4-year bull market in energy prices that peaked in 2008, with the beginning of the *Credit Crisis*. The above quotations were taken from the Fed's monetary policy reports to congress, following the three major energy price increases of 2004, 2005 and 2007 during which time (WTI) prices rose by $11, $18 and $35 respectively. As energy prices had an overwhelming economic impact when they rose a decade ago, there can be little doubt that today's drop in energy prices will work in reverse. An increase to disposable income after energy costs will boost consumer spending, with additional pass-through to the broader economy. We estimate that there will be a net savings of over $1000 on average per household, versus last year, even netting out potential oil & gas related wage losses.

We recognise that substantial job growth over the last few years has materialised from the US fracking industry (doubling over the last 10 years[i]), however, it is unlikely that a significant amount of those jobs will disappear in the short-run, unless oil prices were to drop below marginal costs of production. Although the Saudis have shown no fear of lower oil prices, it would take prices to fall below $US 30[ii] (operating costs + royalties + severance taxes) before US production starts to become non-economic. Still, at current prices, the scope for new projects has largely disappeared, which will impact new job creation coming from the US oil sector.

The other fall-out from the fall-off of energy prices has been diminished inflation expectations. We, like the Fed, are sanguine about the deflationary effects of lower oil prices and believe that the impact will be transitory. Recalling the period between, 2004 and 2007 when oil prices rose, after an initial rise of both overall and core inflation in early 2004, core inflation spent most of the period in the vicinity of 2.25% (according to the Core PCE Deflator). Overall inflation was far more volatile and, for periods, materially higher at closer to 3%. Again, the current experience will likely be in reverse with headline inflation falling below less volatile core inflation – it already has – only to stabalise, once oil prices level out. Note that the current price adjustment has been rapid, with a roughly $60 decline requiring less than six months compared to the four year move a decade ago. At the current pace, beyond the current quarter, there will be little room for prices to fall further.

QE

QE III was laid to rest late last year without much fanfare, but pretty much as mapped out by the Fed. Of course, there is still the small matter of the large balance sheet that the Fed has accumulated, but dealing with it is not a pressing concern, and will only likely become topical if inflation exceeds most forecasts by a considerable amount. The matter of ECB QE is however, pressing. For most of Mario Draghi's term as president of the European Central Bank, he has used his podium, persona and prose to guide the market without having to really commit. But there has always been a risk that a time would arrive when words would not be enough and more action would be required. We are at that time with the zone's economies sputtering, but as has been the problem before, Eurozone politics are getting in the way –

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wasn't that why Draghi resorted to guidance in the first place? The Eurozone is again separated between Germany and the rest, although France and Italy tread the divide carefully. No matter, for now investors have faith in Draghi (what choice do they have?) to perform the QE wonders that arguably were performed across the Atlantic. We are undecided on the outcome in the short term, but believe that at some point, with backs to the wall, Germany will relent – we are not at that point yet.

In any event, European sovereign bond yields have fallen in anticipation of more ECB QE, and investors are realising their profits. 10-Year European sovereign yields are at unprecedented levels ranging from 0.5% for Bunds to 1.9% for Italian bonds in the core, to between 2 and 4% in most of the periphery, all the way to 10% for Greek bonds. The fact that the US offers a safe appreciating currency and safer, higher yielding bonds has not been lost on European bondholders. Hence the concurrent, albeit muted, decline in Treasury (and Government of Canada) yields as investors have crossed the Atlantic.

We don't believe that European sovereign yields could have fallen so low were it not for expectations of ECB

Income vs. Capital Gains

In the last 30 years there have only been three years of negative bond market returns in Canada according to Universe Bond Index data. Will this year be the fourth? The consensus forecast suggests it will be, but the bond market is behaving otherwise. We note that in the years of negative index returns, income contributed ⅓ of the return, while the negative ⅔ of the return came from capital losses. Today it would only take on about an average of 30 basis points sell-off across the yield curve (assuming no change in spreads) to wipe out the average yield of about 2.2% (at time of writing) and another 30 bps sell-off to produce a loss in-line with previous losing years. With bond yields so low and duration so long, bond indices represent very risky investments.

To put the current environment into perspective, ten years ago there were about 75 bps of protection in yields (yield rise before eroding entire yield-to-maturity), and 20 years ago there were about 150 bps of protection. In the 1990's, bonds could truly be thought of as an income investment and capital gains were mostly gravy. (Although, for those of us around at the time, there was no gravy in 1994, as bonds sold off on average around 300 bps, well beyond the 200 bps protection embedded in yields back then.) Despite low overall yields over the last five years, during which time the average index yield has been below 3%, bond market returns have not suffered, with an average index return of 5.52%. However, over the last five years capital gains were responsible for roughly 50% more of the annual return than during the prior 15 years (58% compared to 39%).

Over the last 20 years, the average annual yield move in the bond market was a decline of 56 bps, falling ¾ of the time. Over the last 10 years, the average annual move was only 36 bps, with the 3-year period from 2005-2007 noteworthy, as bond yields remained virtually unchanged during this period. Although bond yields have consistently fallen over the last 20 years, annual volatility has not changed significantly, especially over the last 15. More importantly volatility has not changed in concert with the decline in yield protection offered by the bond market. Today, the average yield protection at 30 bps is below the average yield annual yield move of 40 bps experienced over the last five years. The 45 bps rise in yields in 2013 was more than enough to wipe out the protection in the market at that time.

Assuming the bond market exhibits something close to its characteristic behaviour; it is not difficult to envision a scenario where yields move beyond the protection offered by current yield-to-maturity. If the move in yields is down, something we have already seen in the early days of 2015, the protection will be irrelevant. However, if the move in yields is up, the protection will come into play, likely in a significant way.

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QE; this is certainly true for some of the weaker countries such as Spain and Italy. Additionally, we are not surprised that Bunds and treasuries are hanging on to an historical relationship that has kept the 10-year yield spread pretty much below 150 basis points since the launch of the Euro in 1999. However, we do not foresee endless ECB QE or an endless supply of European demand propping up the treasury market indefinitely, and question whether the Treasury-Bund yield spread will not widen beyond the current support levels. For starters, the ECB will find it difficult to continually enlarge its already bloated balance sheet, given the objections of its most "senior" member. Secondly, we expect fundamentals to eventually overwhelm investment flow, such as it has for the Treasury-JGB relationship. (Although the current 10-year Treasury-JGB yield spread has also narrowed due to falling Treasury yields, historically this spread has been much wider, despite the significant Treasury demand emanating from Japan. Japanese investors are the second largest holder of Treasuries.)

Fed

The *pre-Credit Crisis* Fed would have been a pretty sure bet to raise interest rates a sufficient amount to generate negative returns in 2015, given the trajectory of economic growth and the likely transitory nature of current deflationary forces. But the *post-Credit Crisis* Fed has a different *modus operandi*; what we are dealing with today is a more activist Fed – a Fed that has not yet relinquished control of the yield curve, and whose investor base seems content to patiently await the return of that control. To us, the Fed's game plan would appear to involve controlling every gyration of the yield curve as rates moves through transition to normalization. On more than one occasion in the recent past we have seen the Fed micro-manage the bond market by massaging its words in order to redirect yields after the initial signs of an adverse reaction to data or comments.

Our expectation of the Fed for 2015 is for cautious tightening with a rear-view look at the bond market in case it should find a mind of its own. To this point the Fed has mostly used the guise of labour market slack to temper market response, but one should not be surprised if inflation or European weaknesses are also invoked. To be fair, the Fed has suggested that the impact of oil price declines will be temporary and has mostly underplayed European economic weakness. It would be perfectly reasonable to see a 100 basis point tightening by year end should, as we expect, economic strength persist and deflationary pressures not migrate from headline to core.

$i = r + \pi$

Five year nominal and real US Treasury yields are currently at 1.5% and 0.2% respectively implying that 5-year inflation expectations are now at 1.3%. We find it difficult to reconcile current US economic fundamentals with current real yields and inflation expectations.

For an economy that grew 5% in its last reported quarter, with all signals pointing towards substantial growth in the most recent quarter, and expectations for decent growth going forwards, real yields seem out of whack to us. But, as has been the case for the last few years, central bank policies continue to distort real yields; except that now we are seeing the influence emanating from an outside central bank, rather than from the Fed. It is difficult to know exactly where real US yields should be, while central banks are still engaged in QE and their balance sheets crammed with securities, but we believe they will head higher as QE loses its influence on the US bond market.

As for inflation expectations, we have already referred to the effect of oil prices as being transitory. In our minds, wages have always been key, and in this regard the news is still somewhat ambiguous. Declining unemployment rates (now at 5.6%) would seem to suggest impending wage pressures, but the wage data is not convincing. Wages had shown signs of some

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growth in 2014, with average hourly earnings (HEA) averaging just below 2.0% yoy for the six months to November, but December's HEA were just reported to be a disappointing -0.2% mom. Perhaps minimum wage increases scheduled in nearly half of US states to commence in January will trigger a reversal next month. Still, other data suggest wage growth ahead including the high quit rate, rising consumer net income expectations and growing small business compensation plans. Of course, broadening out of any wage gains will take time, however, we expect investors to eventually take notice and lift inflation expectations.

Current long nominal US treasuries are yielding 2.5%, while similar term inflation indexed securities are yielding 0.7% implying that long term inflation expectations are about 1.8%, slightly higher than current core inflation. Although inflation expectations were about 3% in 2006 – much higher than today, a significant difference in yields between now and ten years ago, is also due to the differential between real yields (according to TIIPS) – now 0.7% versus 1.7% then. There is no magical number to what real yields should be (only flawed assumptions) and they can go negative. Measuring real yields is also difficult, because, although TIIPS and RRB's offer a convenient method for doing so, they are fraught with inefficiencies that impact their yields.

So what to make of the long end of the yield curve? The US yield curve is flattening and may flatten further with any rise in Fed Funds. It remains to be seen how much further the curve can flatten simply from a decline in long yields. Currently, US Treasury 1-year forward rates are pricing in a rise of 75 basis points in 2-year bonds, while only a rise of 8 basis points in the long end, implying a flattening of around 70 bps in the 2-30 Treasury curve. Such a flattening would make the 2-30 spread around 120 bps – last seen during a Fed tightening phase in Feb 2005, when the Fed was in the middle of a 4% increase in Fed Funds. We believe a further flattening of the Treasury curve is likely, but will not prevent long term yields from rising enough to generate negative returns for longer-dated bonds.

Canada

The Canadian economy will have a slightly different experience from the US in 2015. Consumers will benefit from lower energy prices, but contemporaneously, Canada's outsized oil sector will suffer from a reduction in demand and a retrenchment from capital investment. Although the weaker dollar should continue to improve manufacturing exports, businesses that moved offshore during the appreciation of the C$ are unlikely to reappear. The Bank of Canada is likely to lag any move by the Fed, and will conduct monetary policy from the sidelines – perhaps a fifth year of unchanged rates. The Canadian yield curve will most likely steepen, as short rates remain stable and long Canada's track long Treasuries.

Canadian credit markets will generally be supported by economic fundamentals. However, tighter monetary policy from the Fed will be less supportive of riskier assets, which should translate to Canadian markets such as the domestic high yield bond market. A steeper Canadian yield curve should benefit the large number of financials in the Canadian corporate sector. The prospects for provincial bonds will be split according to energy and manufacturing exposure, with bonds from provinces more exposed to the US economy through manufacturing exports to benefit at the expense of bonds from the energy-rich provinces.

[i] According to the BLS, Employment from Oil & Gas Extraction + Support for Oil & Gas has gone from 0.19% in 1994 to 0.39% in 2014.
[ii] Canadian Credit Insights, RBC Capital Markets, December 18, 2014, pg. 8: "Lowering outlook for oil prices", Exhibit 7: Supply costs comparisons (15% IRR)