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What We Think.....

Canadian Yields

For almost five years Canadians had been the beneficiaries of stable monetary policy (albeit with some limited amount of forward guidance) while everywhere around us in other developed countries, central banks were busy either lowering rates or implementing some form of quantitative easing. It is easy to see why just about everyone was surprised when Bank of Canada Governor Poloz lowered Canada's overnight rate by 25 basis points in January without any warning. Not surprisingly, investors had come to expect inaction from the Bank of Canada and, at the very least, some sort of advanced notice should there be an imminent change. But we have a Bank Governor that operates very differently from his predecessor and we have a Canadian economy that is operating very differently from the previous period.

Since the decline in energy prices last fall, signals have been flashing red that the energy-sensitive portion of Canada's economy would be significantly impacted. We doubt whether that fact had been lost on anyone, still monetary policy was already very easy, longer term yields were well below those south of the border and the currency had depreciated from $0.97 to $0.83 since Poloz had taken over as Bank Governor. So when Poloz acted in January, investors were naturally left to wonder why and what next?

In terms of why, we think that Poloz likely had enough anecdotal evidence from the Banks surveys to believe that the impact from energy prices on the Canadian economy would be front loaded and severe. He had already been recognised as a proponent of reinvigorating Canada's manufacturing export sector and was thus likely in favour of a weaker Canadian dollar. Further depreciation of the C$ therefore offered an alternative avenue of effecting monetary policy, while remaining consistent with his already held beliefs. In hindsight, January's move should not have come as a surprise, except that one has to go back to Gord Thiesen and the MCI to find a time when investors paid so much attention to the relationship between the Canadian dollar and the Bank of Canada. Recall, that Carney went to great lengths to distance himself from discussion of the currency.

In terms of what's next, it is difficult to say. Poloz has seemingly vacillated between being preemptive by providing "some insurance" to the slowing economy, to concluding that the rate cut "buys us some time to wait and see", to viewing the effects of the oil slump as "atrocious", all over a relatively short period of time. Given our assessment that the real reason for the rate decline was to provide additional impetus to the Canadian dollar's depreciation, we question whether additional easing would be deemed necessary. The Canadian dollar now sits at 80 cents US which provides plenty export stimulus and, with US interest rates set to rise and Canadian rates at least on hold, it is unlikely that the Canadian dollar will reverse course. In terms of secondary impacts, we remain sceptical that borrowers will meaningfully benefit from another rate decrease, particularly when the last one was only partially passed on by the banks and the Canadian yield curve is already very flat (120 bps long bonds versus overnight as of March). But still, we have not yet figured Poloz out and another rate reduction remains a possibility.

Figure 1. US and Canada 10 Year Yields

Source: Measuring Worth & Lorica Investment Counsel Inc., March, 2015

Our outlook for the Canadian bond market is for stable to lower short term rates with rising longer

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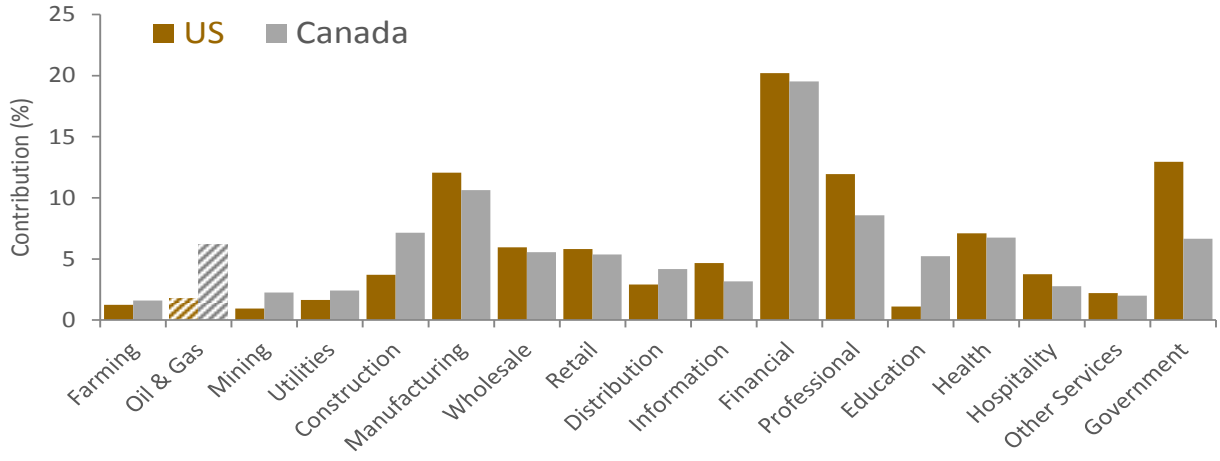
term yields and, hence, a steeper yield curve. While the short end of the yield curve will reflect Bank of Canada policy, the long end will also be a function of the Fed and US Treasury yields. As the Fed has become more persuasive of its intent to raise rates, US bond yields have, not surprisingly, become more volatile – although 10-year Treasury yields declined from 2.17% to 1.92% during Q1, the range was wide: 2.24% to 1.64%. Canadian yields, took a more distinct path downwards, consistent with the bank cut, but their movement was correlated to the movement in treasury yields. (See Figure 1.)

There is no consensus as to when the Fed will begin to raise rates. In the Fed's most recent statement (March 18), it removed the word "patient" suggesting a subtle change of intentions with more openness to raising rates imminently. But to soften this move, Janet Yellen also went out of her way to emphasize the data dependency of the Fed during the subsequent press conference. We have observed that the Fed has been very actively communicating to the marketplace through speeches made by FOMC members that the conditions for higher rates are near. We expect the Fed to raise rates sometime late in Q2 or early Q3, barring some external shock. While data dependency has become the Fed's catchphrase, we note that the US has been out of "abnormal policy" territory for some time and therefore feel it would take worsening data to take them off their path of tighter policy. The Fed has been gradually preparing the market for its next change of policy (QE ended only recently), while attempting to retain a semblance of control over the yield curve.

A note about the recent spate of poor economic numbers. Last year, severe winter weather was responsible for the vast differential between Q1 and Q2 US GDP: -2.1% vs +4.6% (QoQ, SAAR). We expect to see a similar pattern this year, with Q1 US growth now expected around 1.4% (according to Bloomberg's economist survey). Canada's will be even weaker – likely between 0.5% to 1% (according to Canadian bank forecasters). We recognise that lower energy prices will have some negative impact on the economy, but also note that oil & gas made up for only around 2% of US GDP last year. (See Figure 2.) More importantly, we expect the dividend from lower consumer energy expenditures to continue to percolate throughout the rest of the economy as the year progresses. We also expect employment gains to return to trend, and have noted before that we anticipate wages gains, which have been fairly anaemic, to broaden.

Figure 2. US & Canada GDP Contribution by Industry



Source: Statistics Canada, U.S. Bureau of Economics Analysis & Lorica Investment Counsel Inc., March 2015

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Negative Yields

Although real bond yields in the US have been positive for most of the last 50 years, there were prior periods of negative real yields. In the 1970's, implied 10-year treasury real yields were negative due to the high level of current inflation and lower longer term nominal yields from an inverted yield curve. (See Figure 3.) It is difficult to know exactly what inflation expectations were at the time, but until Volcker's aggressive policies, late in the decade, yields were on an upward trajectory because of rising inflation. Recent history has again created an environment for negative real yields, but with substantially different fundamentals. As the Fed aggressively lowered interest rates following the *Credit Crisis* and then executed several rounds of QE, longer term nominal yields declined despite relatively stable inflation. Inflation indexed linked bonds (a gauge not available in the 70's) confirmed these negative implied real yields, having fallen below zero between 2011 and 2013.

Figure 3. US 10-Year Implied Real Yields

Note: Calculated by taking the US 10 Year Yield less Headline CPI

Source: Bloomberg & Lorica Investment Counsel Inc., March 2015

Up until now, there has been no historical precedent for negative nominal yields. The conventional wisdom has been that there is a zero bound to market interest rates and by extension bond yields (see Bernanke's comments in his speech on *Long Term Interest Rates* in March 2013). However, recent experience in Europe has dispelled that notion with nominal yields declining below zero, for maturities all the way up to 10 years, in some countries. There have been cases where central banks have set negative deposit rates to discourage institutions from carrying central bank balances and accommodate ultra-low refinancing rates; in fact, today's ECB has set its deposit rate at -0.2% for this very reason. But, in terms of consumer rates, the assumption has been that the transmission of negative deposit rates through the banking system is limited due to reasons of customer acceptability and bank profitability. Significantly negative rates would jeopardize the operation of money market funds (not necessarily a concern in Europe) and potentially impair bank finances due to the inability to to lower rates for savings accounts in concert with lower deposit rates.

In terms of nominal market yields, the logic behind the zero bound has been quite simple: investors would rather hold cash (presumably under their mattress) than earn a negative yield on fixed income investments, even for the highest quality short term assets. Upon closer examination, it makes sense that there is some price that investors would be willing to pay for the convenience and safe keeping of very short term assets, which could cause short term nominal yields to drop below zero. This so-called "storage cost" explains most of the negative yield on very short term assets seen by retail investors, but not necessarily the yield for longer maturities.

Looking at the yield curves in Switzerland, Denmark, Germany, and a several other European countries, we observe that investors have been willing to receive negative nominal yields even on longer maturities. (See Figure 4.) This proclivity to receive negative yields must relate to factors beyond storage costs; after all, why would investors lock in negative yields for such long periods when they could just hold on to shorter maturities in the hope that yields would eventually go higher? Of course, one would also have to account for the the slope of the yield curve, and factors beyond just "storage costs".

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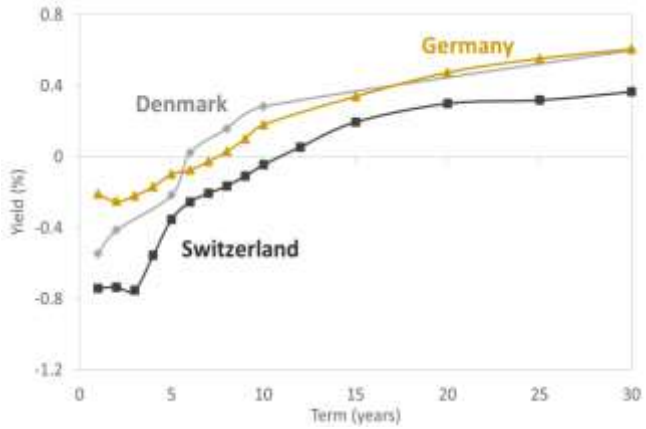
Figure 4. Yield Curves for Denmark, Switzerland and Germany



Source: Bloomberg & Lorica Investment Counsel Inc., March 2015

In markets where longer term market yields are negative, investors are caught in supply-demand imbalances. Inadequate supply is being driven by non-conventional activist monetary policy that has reduced the amount of marketable debt through central bank asset purchases, as has been seen in certain sovereign bond markets. While demand is not proving to be as elastic as once thought, as investors seek safety, regulatory compliance, currency exposure and, in some cases, capital gains, rather than searching for positive yields.

In the case of Switzerland where 2-year yields are currently close to -1%, investors are clearly attracted to the safety of the Swiss Franc and the Swiss banking system, despite the relatively small size and poor liquidity of the Swiss sovereign bond market. Investing in Swiss confederation bonds at negative yields up to 10 years is unquestionably expensive, but does reflect a desire to avoid the riskiness of the Euro and surrounding Eurozone banks. In that context, German yields are a bit more rational, but also negative out to 7 years, with short term yields reflecting ECB deposit rates: 2-year yields are -0.2%. However, 5-year German yields at -0.17% reflect a shortage of mid and long dated bunds particularly given the ECB's Public Sector Purchase Program (PSPP) targets. (See Figure 5.) Anecdotally, investors such as insurers and pension funds are unwilling to sell mid-term Bunds for both investment (scarcity of high quality assets) and regulatory reasons, which has thus contributed to negative yields. This is also true of other countries in the Eurozone, although not to the same degree as in Germany.

Figure 5. ECB QE Target Weights by Country

Source: ECB & Lorica Investment Counsel Inc., March 2015

Although Eurozone inflation expectations have declined significantly (Eurozone CPI is currently running at an area average of -0.1% according to Eurostat), negative nominal yields are not justified purely on this basis. The other components of nominal yields – short term real yields and term premiums – have also had to decline. Historically, monetary policy has had a far greater influence on short term real yields as central banks typically have managed deposit and funding rates to conduct monetary policy. However, central bankers have moved on to alternative policy methods to deal with interest rates close to zero. These policies, including QE and forward guidance, have significantly altered term premiums along the yield curve where economic fundamentals may have suggested something else. We would argue that the bond market's ability to provide effective transmission of information through market yields has been compromised by these alternate monetary policy methods. Although we have already witnessed the impact of QE in the Japanese and US bond markets, the move to negative nominal yields in Europe has thus taken the effect of QE to a whole new level.