June 30, 2017

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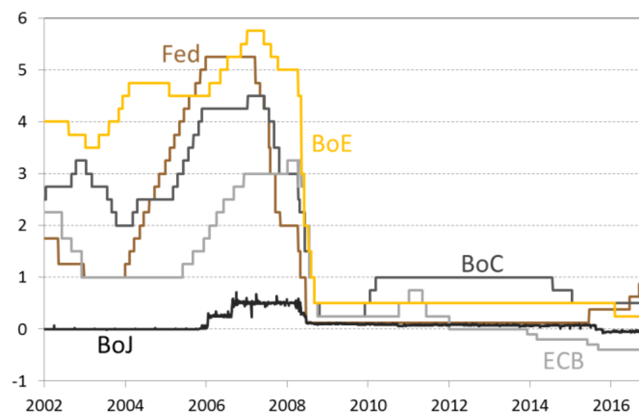
What We Think...

Central Banks in Sync

In the years following the credit crisis, central bankers had earned hero status, having turned the possibility of a depression into the “great recession”. However, in recent years, central bankers seem to have lost a good amount of credibility despite having laid the foundation for possibly, the longest (albeit possibly the shallowest) economic recovery in US history – as of writing we have had 96 months of US growth, shy of the US record 120 months. Critics question the means, cost and even validity of avoiding what *may* have just been a recession. Central bank balance sheet growth, sovereign yield curve manipulation, too much indebtedness, excessive risk taking and asset price extremes are amongst the most noteworthy (and still not fully understood) side-effects of post-crisis monetary policy. Although it is impossible to know what might have happened had there been no ZIRP, forward guidance and QE, there are many who wonder if these policies only supported an outcome that would have happened anyways, while creating more problems down the road.

We have made it clear in recent commentaries that we have not been enamoured with the way the Federal Reserve Board has managed policy in the last few years. We had seen too many false signals and too much stage fright getting in the way of efforts to normalise interest rates and bond yields, and unwind the Fed’s balance sheet. We had also become very skeptical of the merits of manipulating the yield curve to such an extent where risk taking by investors was encouraged but not so for businesses. Of course, the argument has been made that investor risk-taking inflates asset prices creating a wealth effect that translates into consumer spending and overall economic gains – we believe that the effects are too narrow to generate anything more than shallow growth. As for the false signals, it had become clear that, while the Fed had sufficient opportunities to begin raising interest rates, they did not have enough confidence in the economy or asset prices to do anything more than give lip service. The election seemed to provide the cover the Fed needed to, finally, take some bigger risks with the normalisation process. The Fed began raising rates in December of 2015 with the first rate increase in 9.5 years, followed by another 12 months later, and then another last March – the pace of increases having clearly accelerated. Admittedly, the Fed has learned from the mistakes of the Taper Tantrum and been able to begin the normalisation process without a major disruption to capital markets.

Figure 1: Central Bank Policy Rates



Source: Bloomberg & Lorica Investment Counsel Inc., June 2017

After 115 months of easy monetary policy from the Fed, about 104 months from the ECB and the Bank of England and 115 months from the Bank of Canada we now have major central banks speaking from the same general policy page. (See Figure 1) Not surprisingly, the BoJ is not on the same page, and we doubt to see that change anytime soon. However, we do expect to see the Reserve Bank of Australia adopt a tighter policy in the near future.

Given the depth of policy easing that has taken place, none of the Central Banks have really changed direction yet, but rather are decelerating towards neutral, either through guidance or explicitly by raising rates. It will take some time for policy rates to reach a new neutral. (Several quarters ago, we talked about the popular efforts by central bankers to redefine the *natural rate of interest* to a level substantially lower than what is conventionally accepted. This discussion seems to have

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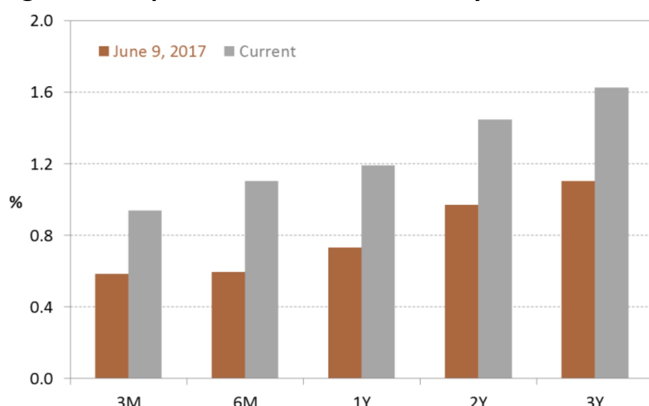
died down as the Fed has maintained its trajectory as illustrated in its dot plot disclosures.)

The Fed has taken the lead on reversing easy monetary policy, initially with the tapering of its balance sheet purchases followed by the dissemination of its dot plot projections for policy rates, which depicted a reasonably aggressive upward trajectory. The latest policy normalisation initiative was the outline of a plan to unwind the Fed's balance sheet, presented in June following the FOMC meeting. Also in June, the ECB and Bank of England heads indicated tighter policy biases.

Figure 2: Implied Bank of Canada Policy Rate



Source: PC Bond & Lorica Investment Counsel Inc., June 2017

As for the Bank of Canada, it made perhaps the biggest splash with its June policy shift.

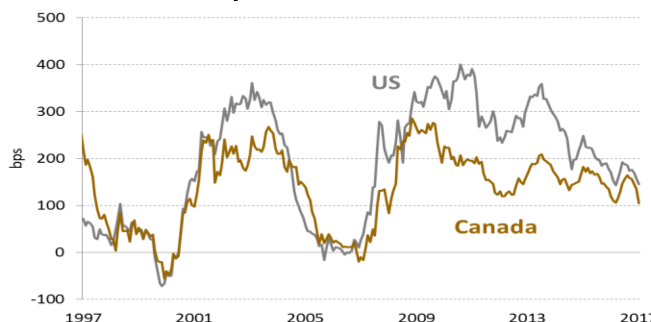
It began with Senior Bank Governor, Carolyn Wilkins' speech to The Associates of the Asper School of Business on June 12th during which she said: *"… when you look at the economy from different perspectives, there is reason to be encouraged. Growth has been robust in recent quarters. … stronger growth is translating into job gains across a wider range of regions and sectors. At present, there is significant monetary policy stimulus in the system."*

The next day, Governor Poloz followed with an interview on CBC radio during which he said the following: *"It isn't time to throw a party, but it does suggest that the interest rate cuts we did two years ago have done their job, and that's important to us."*

The Bank's message was echoed by other members of the Bank's governing council, leaving little doubt as to their intentions and even urgency. The June comments indicated a dramatic policy change by the Bank. Investors were clearly caught by surprise and had to shift expectations for the currency and bond yields. The Loonie and Canadian yield curve adjusted quickly, with the Loonie increasing by 2.9 cents against the US dollar, 2-year yields rising by 35 bps (after being locked in a 75 bps range for 6 months) by quarter-end and 10-year yields rising by 33 bps. Probabilities for rate hikes in 2017 were immediately increased. (See Figure 2)

As of writing, short and mid-term yields are higher than where they began the year, with long-term yields slightly lower. The change in the yield curve to mid-year reflects two different dynamics at play, one made-in-Canada, the other driven by events outside. Two and five-year yields are respectively 35 and 31 bps higher than where they began the year, the result of a combination of Bank of Canada policy repositioning and Fed policy conviction and credibility. Long-term yields are -5 bps lower, mostly because of declining inflation expectations and lower long Treasury yields due to deteriorating prospects for stimulative economic policies in the US; lower European yields have also had an impact. Ten-year Canada yields are up 7 bps this year, somewhere in between short and long bonds, having faced the crosscurrents of domestic and global factors.

Figure 3: US & Canada Sovereign Yield Curves – 30 less 2 years



Source: Bloomberg & Lorica Investment Counsel Inc., June 2017.

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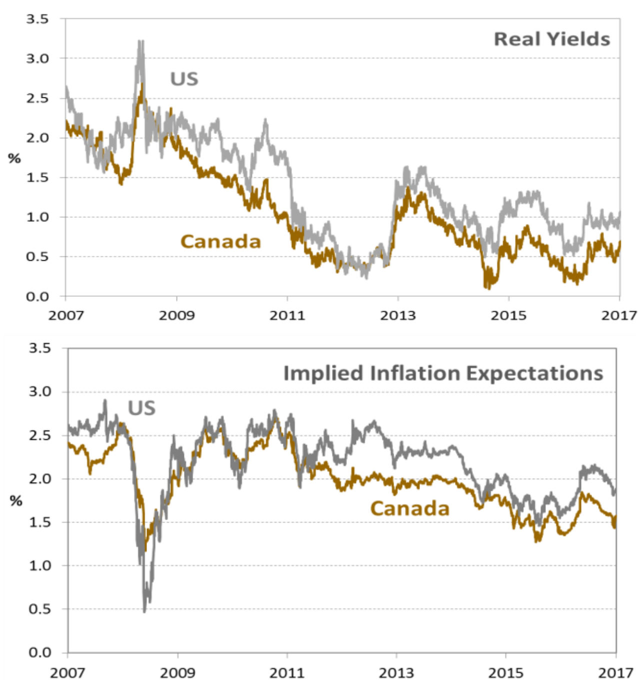
Overall, the Canadian yield curve has continued to flatten (something we highlighted last quarter). (See Figure 3) We think this flattening is dramatic and unwarranted, and we expect to see a realignment of the curve over the remainder of the year.

Looking more closely at longer-end of the yield curve, the biggest driver has been the decline in long-term inflation expectations and real yields. (See Figure 4) Implied long-term inflation (the difference between long Treasury and long TIP yields) has declined by 30 bps year-to-date, while the comparable move in 10-years is 21 bps and the 5-year, 5-year forward inflation expectation rate (a Fed favourite) shows a decline of 23 bps. Long real yields have increased by only 6 bps year-to-date compared to 15 bps for 10-year real yields.

Figure 4: Canada & US Long-term Real Yields & Implied Inflation Expectation

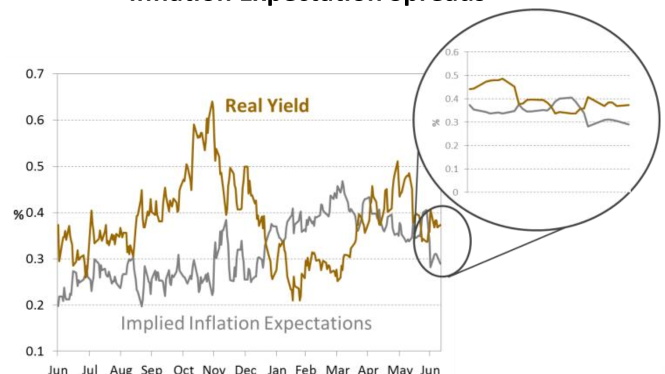


Source: Bloomberg & Lorica Investment Counsel Inc., June 2017.

So why the big discrepancy between the move in 10-year and long bonds? Some analysts suggest that the flattening of the yield curve is forecasting a recession, suggesting that underlying fundamentals such as falling inflation, over-indebtedness, the lack of wage growth and a tightening Fed are all warning signs. In our view, the curve is still early in the process of undoing the distortions created by asset purchases and other non-conventional monetary policies. The lack of liquidity in the long-end of the US bond market continues to play out with excessive moves when investors decide to add more duration. Despite tighter monetary policy from the Fed, investors have soured on the prospects of US government stimulus, appear tired of waiting for signals of wage growth, and have been willing to extrapolate low inflation into the future. T-Bond future's positions still indicate overall long positions despite some recent selling. We believe investors are too complacent on inflation, and expect to see expectations increase as the year progresses.

The movement of Canadian real yields and inflation expectations have generally tracked those of the US. As the Fed started to tighten policy and the Bank of Canada lowered rates, the spread between US and Canadian real yields widened. Subsequently, with the Bank indicating a move off the sidelines, Canadian real yields have moved to close the gap with those in the US (See Figure 5). We expect the narrowing to continue as the prospects for the Canadian economy improve and the Bank signals more rate increases.

Figure 5: US vs Canada Long-term Real Yield & Implied Inflation Expectation Spreads



Source: Bloomberg & Lorica Investment Counsel Inc., June 2017.
Note: 10 Year RRB & TIIPS used

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Non-Viable Contingent Capital

Or NVCC, as it is commonly known by, has been a big topic of discussion in the Canadian corporate bond market since this kind of debt instrument first surfaced back in July 2014. Canadian financial institutions have had a long history of issuing subordinated debt with conversion features (Tier 1 and Tier 2A hybrids). The use of subordinated debt enables optimised capital structures, which has become even more important into today's highly regulated environment for financial institutions. The most recent innovation, NVCC is certain to have an impact on the issuance of Canadian banks going forward.

The key feature of NVCC that permits its use as regulatory capital is the contractual requirement of conversion of subordinated debt (and preferred equity) into common equity upon the occurrence of a "trigger event", as determined by OSFI. The purpose of this conversion feature is to guarantee the viability of the financial institution without the need for a government bailout (clearly fallout from the 2008 financial crisis).

In April of 2016, the Canadian Federal Government introduced in its budget, legislative framework for a "bail-in" regime for domestic systemically important banks (D-SIB). At the time, many of the details of the regime were not established and were to be tabled at a later date. That later date arrived on June 14, 2017, when the department of finance draft bail-in regulations defining the basics of the regime, and asking for public comment until July 17th. (OSFI published its draft guidelines for loss absorbing capacity, to ensure D-SIB can absorb losses while being recapitalized, also for public comment.)

The key points of the draft regulations are:

- No retroactivity of bail-in applied to instruments issued before legislation is passed.
- Long term unsecured senior debt over 400 days to maturity that is tradable and transferable is eligible for bail-in conversion.
- Excluded from bail-in are deposits, secured liabilities, eligible financial contracts or structured notes.
- Canadian Deposit Insurance Corporation (CDIC) has discretion over debt to equity conversion rate.

The likely process in the event of non-viability would consist of:

1. Determination by the Superintendent of Financial Institutions that bank is no longer viable and approval by the CDIC Governor in Council to take control.
2. CDIC takes temporary control of the bank for conversion of NVCC and, if necessary, execution of the bail-in to restore viability.
3. If the bail-in is executed, it must be returned to private control (within one year).
4. Compensation must be paid to relevant shareholders and creditors.

A relevant issue for bond investors is the treatment of Bail-in and NVCC bonds in bond indices and policy statements. In June, FTSE Russell announced the following:

- *Upon confirmatory review of the final structure, we expect Bail-in bonds issued by Canadian financial institutions will be eligible for the FTSE TMX Canada Universe Bond Index once issued.*
- *Newly issued (settled on or after 1 July 2017) non-viability contingent capital (NVCC) bonds will become eligible for the FTSE TMX Canada Universe Bond Index effective 1 July 2017.*
- *NVCC bonds issued prior to 1 July 2017 will not be immediately added to the FTSE TMX Canada Universe Bond Index as a result of this announcement.*

We anticipate due to the Canadian D-SIB's having a penchant to capitalize well beyond regulatory minimums that Bail-In and NVCC bonds will ultimately constitute almost all Canadian bank bonds outstanding, which will represent up to a third of the corporate bond market.