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What We Think...

Government Yields

It has been almost one year since the US election, but in terms of implementation of President Trump's economic agenda, not too much has happened. Yet the US stock market is up 18% (S&P 500 Index), US corporate and high yield spreads have narrowed by 30 and 144 bps respectively (Bloomberg Barclays US Corporate Bond Index and BofA Merrill Lynch US High Yield Option-Adjusted Spread). Perhaps most significantly for capital markets, the Fed is no longer scared to tighten policy, although markets seem the least bit concerned.

Following the US election, we were hopeful enough to suggest that it was reasonable for the market to price in a 50/50 chance of economic-friendly policies under a Trump government, relative to what could reasonably have been expected during the Obama years. It is debatable, how optimistic investors ultimately were following the election. However, from a bond market perspective, the immediate response was a relatively quick steepening of the yield curve led by a back-up in longer-term yields – the 2 to 30-year slope increased by 28 bps to 204 bps, 30-year Treasury yields peaked at 3.21%, a rise of 60 bps, and the US dollar rose by 5% on a trade-weighted basis. Since the peak in yields, the problems in the White House, which have included continuous staffing turnover, confusion and disappointment over immigration, health-care and trade policies, the election interference saga, and continuous confrontation with the press, have caused bond investors to take the "Trump premium" out – from March 13th to September 7th 10-year Treasury yields fell by 59 bps.

The latest reversal in yields – 10-years are up 29 bps since September 7th, is in our view, less about renewed optimism over government policy, and more about changing fundamentals and expectations for monetary policy. It is true, there is some anticipation that tax reform will be more successful than previous policy initiatives, but we doubt that bond investors have gotten overly confident over the extent of eventual policy change. The voting margin for republicans in the senate is slim and the attempts at overturning Obamacare showed that passing legislation through the republican majority is surely not a given.

Federal Reserve communication is likely the most instructive on why investors have pushed bond yields higher. The Fed has cautioned that there are dangers getting behind the curve on inflation, while outlining its plan to tighten policy with a combination of rate hikes and balance sheet unwind. Investors have responded clearly by pricing in further rate hikes into the market – Fed Fund futures now indicate that a majority of investors expect 3 (25 bps) rate increases over the next twelve months. (See Figure 1.)

Figure 1: Fed Funds Future Implied Rate Hike Probability (%)

	Number of Hikes	1	2	3	4+
FOMC Meeting Dates	Nov-01-17	99.7	0.3	0.0	0.0
	Dec-13-17	23.3	76.5	0.2	0.0
	Jan-31-18	22.1	74.0	3.9	0.0
	Mar-21-18	13.6	54.0	30.9	1.5
	May-20-18	13.2	52.8	31.6	2.3
	Jun-13-18	9.6	41.9	37.4	11.1
	Aug-01-18	9.3	41.0	37.5	12.0
	Sep-26-18	7.2	34.0	38.3	20.4

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

Notwithstanding the recent disruption to the labour markets from hurricanes Harvey and Irma, US employment gains have been steady with Non-farm payrolls averaging 148k over the last 12 months and unemployment dropping to 4.2%. Wage gains, however, have been more stubborn with average hourly earnings hovering around 2.5% yoy; September's numbers were encouraging at 2.9%, but also hurricane distorted. Although core inflation is well below the Fed's target of 2%, running 1.3% yoy to August, Yellen and co. appear determined to continue normalising rates. We think the Fed is wise to capitalise on cooperative financial markets (no "taper tantrums") and reasonable economic numbers.

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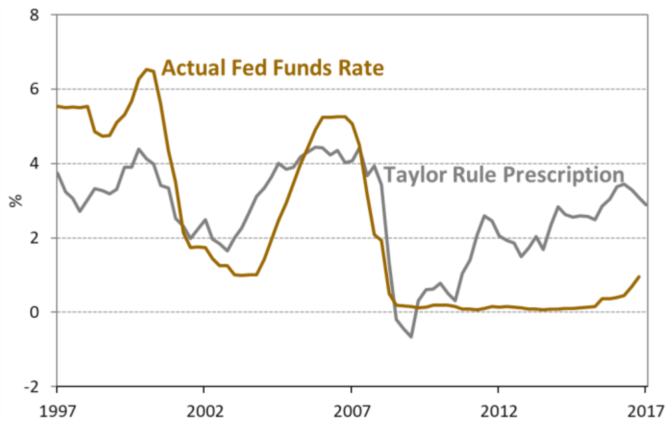
Figure 2: Effective Federal Funds Rate and Taylor Rule Prescription (Quarterly Average)



Source: Federal Reserve Bank of Atlanta & Lorica Investment Counsel Inc., October 2017

It is worth noting that there are a significant number of detractors of the Fed's desire to tighten policy, criticizing the Fed for appearing to move closer to the Taylor Rule* in its endeavour to normalise rates. Recall that at the 2016 Jackson Hole Economic Policy Symposium hosted by the Kansas Fed, Fed Chair Yellen spent considerable time outlining a monetary policy framework around the Taylor Rule. At this year's Jackson Hole, Yellen went to great lengths to describe reasons for having deviated from the Taylor Rule over the last decade, but nevertheless emphasized its guidance (together with the "balanced approach" and change rules) when adjusting monetary policy. Thus, given the Fed's subsequent policy rate projections (and balance sheet plans), some commentators have interpreted the Fed as intentionally following the policy trajectory prescribed by the Taylor Rule. (See Figure 2.)

The current environment surrounding the Fed and Fed policy is particularly interesting given the number of vacant seats on the FOMC, the resignation of Vice Chair Fischer (effective mid-October) and most importantly, the imminent appointment or reappointment of the Fed Chair (President Trump has indicated a decision within the next two weeks). While appointment of 3 of the 4 leading?' candidates for Fed chair – Powell, Cohn and Yellen – would, in our estimation, likely result in no major shift in tenor of the Fed; appointment of the fourth – Warsh – could imply a steeper trajectory to higher rates than what has been communicated by the existing committee. (See excerpt from Kevin Warsh's WSJ opinion/commentary: **America Needs a Steady, Strategic Fed**, page 4.) Of course, there is also the possibility of a dark horse candidate. But at a minimum, we expect a new chair and a substantially different looking committee next year (Randal Quarles was confirmed by the Senate last week for one of the vacant committee positions). Admittedly, we have difficulty reconciling a more hawkish chair with President Trump's apparent preference for low rates (admittedly Trump's positions are often unpredictable).

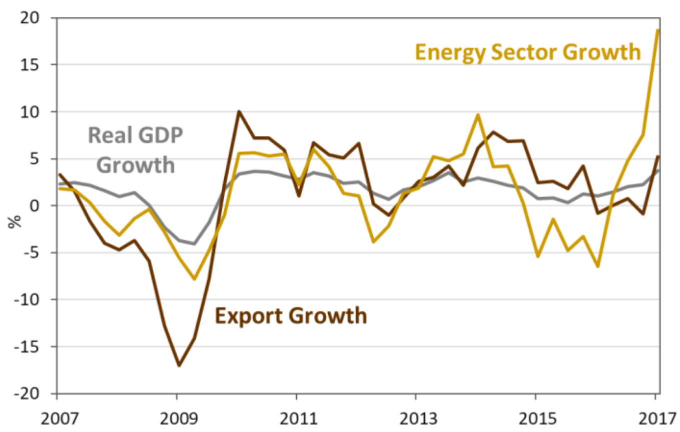
The future of the Bank of Canada and BoC policy is far more certain than its Southern peer. Governor Poloz is serving his 5th year of a 7-year term, Senior Deputy Governor Wilkins, her 4th also of 7, while of the four deputy governors, only Timothy Lane has been at the Bank more than 4 years. In terms of policy, the biggest uncertainty facing the Bank originates south of the border, from developments surrounding NAFTA negotiations. There are no precedents for the renegotiation of NAFTA, and predicting the outcome of the trilateral discussions is next to impossible. It is reasonable to assume that some of the changes to NAFTA (we assume there will be changes) may be benign for the Canadian economy and the Bank. However, there is also the probability of negative outcomes for the Canadian economy, and even the possibility of a disastrous outcome. Discussions are

** The Taylor Rule, devised by Stanford economist John Taylor, states: "real" short-term interest rate (that is, the interest rate adjusted for inflation) should be determined according to three factors: (1) where actual inflation is relative to the targeted level that the Fed wishes to achieve, (2) how far economic activity is above or below its "Full employment" level, and (3) what the level of short-term interest rate would be consistent with full employment. Federal Reserve Bank of San Francisco, March 1998.*

approaching a critical stage, and we should know what to expect, relatively soon.

The domestic Canadian economy has been surprisingly strong in 2017, giving the Bank of Canada the cover to reverse its two rate reductions of 2015. Investors were caught off-guard with the hikes, mostly because there was little forewarning from the bank; in hindsight it should not have been such a surprise as real growth was running at 4.6% at the time of the first increase and the unemployment rate had fallen back down to 6.3%. The challenge to rate normalisation for the Bank will be trade – both current and future NAFTA-related. Exports have been largely disappointing, with much of the favourable data being energy-related. (See Figure 3.) Improving world growth will support energy prices, but significant reserves from fracking and traditional sources will keep a lid on prices.

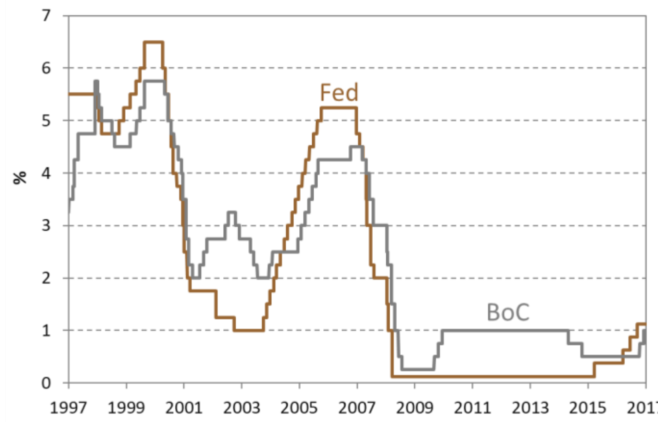
Figure 3: Canada Real GDP, Exports & Energy Sector Growth



Source: Statistics Canada & Lorica Investment Counsel Inc., October 2017

Notwithstanding NAFTA, we expect Canadian and US monetary policies to track relatively closely. Rate policy between the two countries are the most consistent they have been in 7 years (see Figure 4), albeit with the US also in the process of commencing the reversal of QE. Politics-permitting, we expect the Bank to similarly follow a path to rate normalisation.

Figure 4: Policy Rate of Federal Reserve & Bank of Canada



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

Credit Spreads

Provincial bonds are trading at relatively narrow yield spreads, driven by demand from international investors looking for high quality longer-term debt. Provincial bonds are unique in this regard, given their spread over Canadas, the preference of provincial treasurers for long maturities, and the willingness to issue both domestically and in foreign currencies. Given the solid demand for provincial bonds, we are not overly concerned about the limited protection that provincial bonds offer to widening yield spreads, noting that provincials still offer more protection to rising Canada yields than similar-term Government of Canadas.

Within the provincial sector, the spread relationship between provinces has undergone change over the last couple of years as the relative stature between provinces has shifted. (See Figure 5.) The boom-bust of the Alberta energy sector has translated into wider spreads against the eastern provinces, while the improving finances of Quebec versus the deterioration in Ontario has meant that Quebec-Ontario spreads have stabilized in negative territory. We are not expecting a material change to the current intra-provincial spread relationships.

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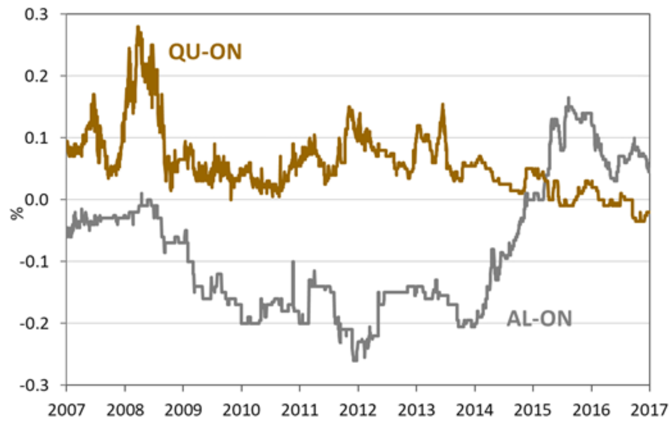
Figure 5: Quebec & Alberta versus Ontario 10-year Yield Spreads



Source: FTSE TMX Global Debt Capital Markets Inc. & Lorica Investment Counsel Inc., October 2017

Persistently low government yields have helped sustain the bid for US and Canadian corporate bonds, keeping corporate yield spreads at extremely narrow levels. Both investment grade and high yield spreads are close to their narrowest levels since the credit crisis began, despite recent tighter monetary policy from both the Fed and the Bank of Canada. The last decade of accommodative monetary policy, featuring QE from the Fed, has encouraged investors to own the increasing amount of corporate debt issued. (The Bloomberg Barclays US Aggregate Bond Index and FTSE TMX Canada Universe Bond Index have corporate weights of 26% and 27% respectively (up from 19% and 13% twenty years ago). Furthermore, most non-indexed investors hold corporate overweight's despite deteriorating credit quality and rising corporate defaults.

We have been comfortable with significant corporate weights in all our core portfolios, but have steered towards the short-to-mid part of the yield-curve where break-evens are more attractive. In addition, the overall positioning of our portfolios with relatively short durations, with few or no long bonds, facilitates such an overweight using cash securities, without the need of derivatives.

Excerpt from: **America Needs a Steady, Strategic Fed,** When central bankers react to short-term data, they confuse the immediate with the important. Opinion/Commentary by Kevin Warsh for the **Wall Street Journal,** January 30, 2017.

Here is what reform of Fed strategy might look like in practice:

First, the Fed should establish an inflation objective of around 1% to 2%, with a band of acceptable outcomes. The current 2.0% inflation target offers false precision. According to the Fed's preferred measure, inflation is running at 1.7%, only a few tenths below target. The difference to the right of the decimal point is too thin a reed alone to justify the current policy stance. It also undermines credibility to claim more knowledge than the data support.

Second, the Fed should adjust monetary policy only when deviations from its employment and inflation objectives are readily observable and significant. The Fed should stop indulging in a policy of trying to fine-tune the economy. When the central bank acts in response to a monthly payroll report, it confuses the immediate with the important. Seeking in the short run to exploit a Phillips curve trade-off between inflation and employment is bound to end badly.

Third, the Fed should elevate the importance of nonwage prices, including commodity prices, as a forward-looking measure of inflation. It should stop treating labor-market data as the ultimate arbiter of price stability. The cost-push wage inflation of the 1970s is fundamentally different from the later-cycle wage increases that we're starting to see now. A material catch-up in wages after a long period of stagnation need not trigger a panicky response.

Fourth, the Fed should assess monetary policy by examining the business cycle and the financial cycle. Continued quantitative easing—which Fed leaders praise unabashedly—increases the value of financial assets like stocks, while doing little to bolster the real economy. Finance, money and credit curiously are at the fringe of the Fed's dominant models and deliberations. That must change, because booms and busts take the central bank farthest afield from its objectives.

Fifth, the Fed should institutionalize its new strategy and boldly pursue it with a keen eye toward the medium-term. Central bankers who vow allegiance to "data dependence" find themselves lurching to and fro according to undistilled, short-term noise. Instead, the Fed should adhere to a concept I would term "trend dependence." When the broader trends begin to turn—for example, in labor markets or output—the Fed should take account of the new prevailing signal.