September 30, 2018

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What We Think...

Bond Yields Head Higher

Following the election of Donald J. Trump, markets were euphoric. There was anticipation of animal spirits being unleashed in the US economy and investors were willing to bid-up risk-assets to take advantage. US equity markets returned 12.76% (according to the S&P 500 Index) and Treasury yields rose by 77 bps to 2.63% (according to the Bloomberg 10-Year constant maturity series) from Nov/16 to Mar/17. Talk of tax cuts, deregulation and re-writing of trade policy all fuelled expectations of greater economic growth. However, investor expectations gradually subsided as the government focus shifted away from economic issues – equity markets stalled and by Sep/17 10-year Treasuries had fallen to 2.04%. It has been nearly two years since the election and US equity markets and bond yields are much higher: 2931 – an all-time high for the S&P 500 and 3.23% - the highest 10-year yields since 2011.

US economic growth is strong, having delivered 2.9% over the last twelve months. Growth has generally broadened across the economy, but inflation has remained relatively benign. In the early years of recovery after the credit crisis, employment grew at a moderate pace (below historical experience of recoveries) with little visible pressure on wages. With unemployment now at the lowest level since 1969 at 3.7%, wage expectations have predictably risen. The Federal Reserve is responding with greater conviction behind its monetary policy, employing a combination of higher policy rates and guidance, and balance sheet reduction. Fed chairman Powell has been clear about the Fed's tightening program with the Fed dot plots currently indicating approximately 25 bps rate increases per quarter for the next twelve months. Markets are less sanguine, expecting only 3 hikes over the next four quarters. While short-term yields have continued to rise along with the Fed's dot plot guidance, longer-term yields had shown more volatility, and had lagged the rise of shorter maturities. Consequently, the Treasury yield curve had flattened towards inversion, leading many adherents of the "yield curve as an economic predictor", to suggest that the curve's shape is indicative of recession not far off, consistent with many past inversion episodes.

We have examined the history of the Treasury curve looking at periods of Fed policy increases, flat/inverting yield curves and recessions. (See Figure 1.) From 1976 there have been 5 recessions which have all been preceded by an inverted yield curve coinciding with a Fed tightening cycle. On average the yield curve has inverted to -125 bps with a preceding flattening of 317 bps over 22 months. However, there are two tightening episodes: Apr/87-Sep/87 and Feb/94-Feb/95 where the yield curve did not invert, hitting lows of 90 and 9 bps respectively. In the two "non-inverting" cases the curve subsequently steepened before facing another sequence of policy rate increases that resulted in inversion and ultimately recession. We think that the current episode will be more like a drawn out "flat curve" episode where the curve steepens before moving to inversion and recession.

Why do we expect the yield curve to resist inversion? We have seen some expansion of term premiums and we expect this to continue with further domestic growth. Tighter monetary policy from both the ECB & BOJ will also support expanded term premiums. Inflation expectations have been stable, but steady wage growth is starting to push these expectations higher. Thus, we expect mid and long-term nominal yields to rise with a rise in underlying real yields and inflation expectations, also adding to the forces acting against inversion. In Canada this dynamic will be exaggerated as the spread between US and Canadian real yields gradually narrows, now that some of the Canadian economic risk has been removed. We do not expect to see the spread between US and Canadian inflation expectations narrowing quickly, given the tighter labour markets in the US and weaker growth expectations for Canada.

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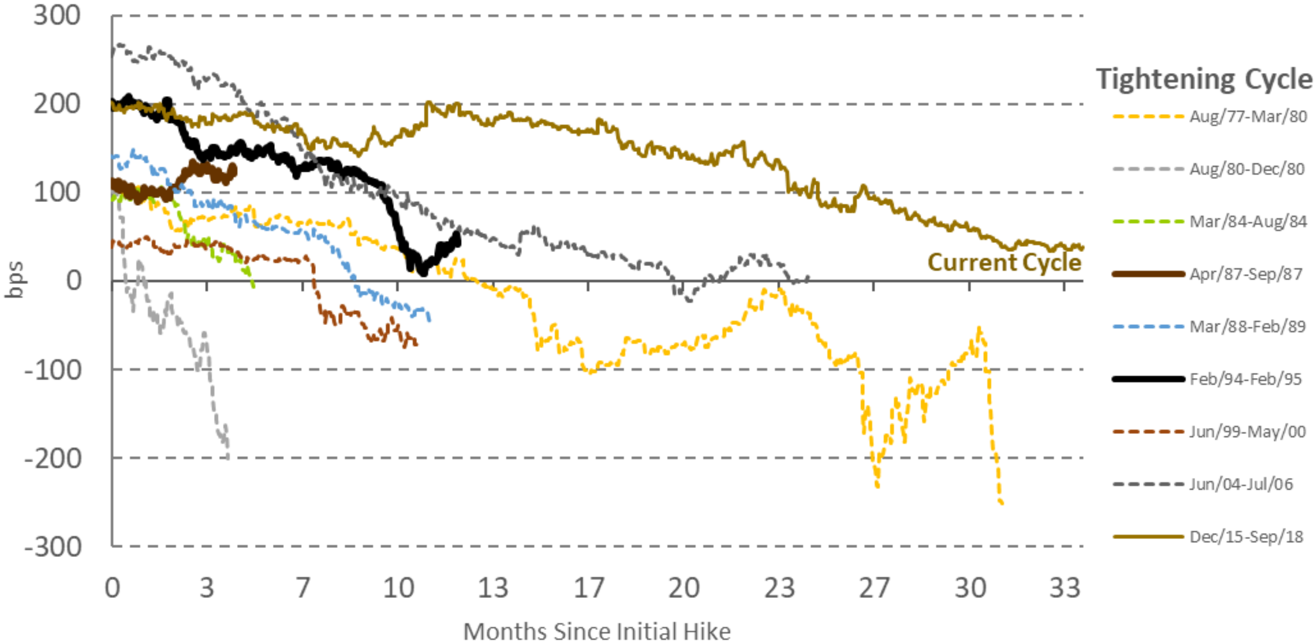
Figure 1: Fed Tightening Cycles & 2-30's Treasury Yield Curve Slope



Source: Bloomberg & Lorica Investment; Sept 2018

Most skepticism over the prospects for the US economy lies with: i. questions of the durability of the Trump tax cuts (that have generated business enthusiasm); ii. the increasing scarcity of productive labour; and iii. the effects of rising interest rates. We think all the above, will eventually become a problem for the economy, but we are not worried yet.

Private non-residential investment has been robust, and we expect this to continue over the next year, especially given much of the benefit from tax cuts is still in the pipeline as are knock-on effects.

We think the scarcity of qualified labour will be the first factor to become an issue for the economy, albeit not by pushing the economy into recession, but by exerting more upward pressure on inflation. We are already seeing signs of wage pressures – average hourly earnings are expected to show 3%+ annual increase next month and are likely to continue, assuming the economy does not slow. There does not appear to be a case for significantly more labour force participation at this point – we do not think the case can be made for a large supply of discouraged workers (a preoccupation of the Yellen Fed), or a change in the supply of qualified labour. Eventually, the shortage of skilled workers will cap growth of the US economy. Unfortunately, population aging, reduced immigration, insufficient worker education and falling women participation are all consistent with a shrinking labour force. Efforts to alter the demographic trends will be slow to materialise.

Finally, should real yields and inflation expectations continue to rise, we are likely to see higher nominal yields across the yield curve. Wage growth should provide some cushion for the consumer against higher borrowing costs. However, the large amount of leverage in the economy means that consumers and businesses will ultimately be impacted by higher rates. Again, we don't see this as an imminent problem.

Overall, we think that the US economy will prove resistant to the major threats (mentioned above) over the next couple of years. There are of course other non-homogeneous threats related to domestic politics

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and geo-politics, especially as it relates to international trade. The Trump administration is very unpredictable, and we do not anticipate that to change. Of the known-unknowns, trade relations with China is the greatest wildcard. The current tariff war will likely mean slower growth, than would otherwise be the case, for the global economy, including the US, and higher inflation in the US. It is hard for us to see any real positive near-term impact to the US economy, especially given tight labour markets. China is likely to feel some pain, but we expect to see it follow past practice and boost growth through increased government spending, while looking to expand trade elsewhere.

The Canadian economy has surprised with its resilience, especially considering the danger to its US trade relationship that it has been facing for over a year. Employment growth has produced an average of 16,000 jobs per month over the last twelve months and an unemployment rate of 5.9%. Growth has been 2.4% yoy for the year ending September. Despite strong Canadian economic growth, the Bank of Canada has had to tread more carefully than the Fed, given the risks to the economy, which include consumer debt levels, energy prices and trade, particularly in light of the NAFTA negotiations. The consumer has maintained its leadership over the Canadian economy, partly through borrowing, and undeterred by macroprudential regulation, tepid wage growth and rising interest rates. Non-residential investment and trade have been disappointing, despite low interest rates, low unemployment, a weaker loonie and higher oil prices. There is hope that the generally benign recasting of NAFTA into the US-Mexico-Canada Agreement will create a more favourable environment for foreign investment and trade; however, we have our doubts. For most of the last decade, Canada's exports have been a function of the price of oil (handicapped by Canada's poor access to global oil export markets) and non-competitiveness, amplified by the currency. We do not expect Canada's trade picture to show much improvement in the near term.

For the first three quarters of the year, the Canadian bond market had outperformed the US bond market, as investors had discounted Canadian growth expectations and Bank of Canada policy moves due to the uncertainty surrounding a North American trade agreement. We felt that this was prudent, given the difficulty associated with predicting an outcome to negotiations and the seriousness and reality of threats of more US tariffs. We expect the Canadian bond market to underperform for the remainder of the year, as markets adjust to a more certain "Canadian" outlook and the Bank rejoins the "hawkish" central bank crowd. The Canadian yield curve has been flatter than the US yield curve for most of the year, although this is now no-longer entirely the case. (See Figure 2.)

The 2-10's Treasury and Canada slopes are now virtually identical as that part of the Canadian curve has recently steepened. Interestingly, the 10-30's Canada curve is still much flatter than the similar Treasury curve, owing to an inherent supply/demand imbalance in the long-end of the Canadian bond market. Demand for Canadian issued long bonds is considerable from both domestic investors – e.g. pension funds, insurers and retail funds, and from foreign investors looking for liquid high quality higher-yielding long duration assets (such as those found in the Canadian provincial market).

Figure 2: 2018 Spread Between US & Canada Yield Curve Slope – 2-10's & 10-30's

Source: Bloomberg & Lorica Investment; Sept 2018

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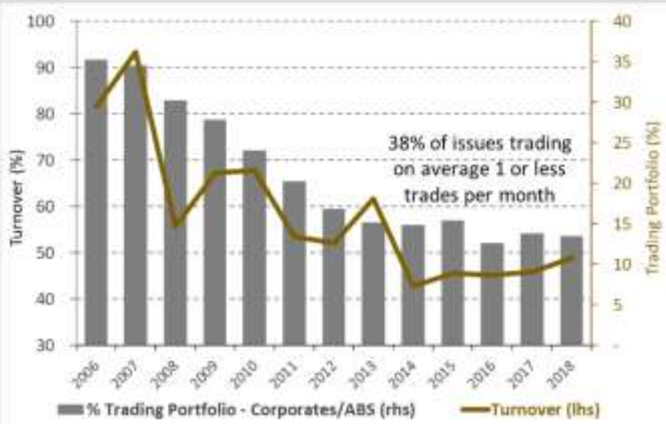
Liquidity Risks in the Corporate Bond Market

The risk-on behaviour in capital markets has resulted in contraction of corporate yield spreads and intra-corporate spreads across ratings. The persistent low yield environment has encouraged investors to take on corporate risk with low levels of yield protection and seek additional yield by moving down the credit quality curve. While we have been comfortable with overweighting our portfolios with corporate bonds, our preference has been to maintain good quality, liquidity and protection (in the form of shorter duration). Higher overall bond yields will favour those corporates more exposed to the bond market such as lenders and insurers. As central banks continue to raise rates and bond yields respond to higher real yields and inflation expectations, those corporations with more leverage will see higher refinancing costs and declining balance sheet fundamentals. Bond market liquidity, which has been ignored since the credit crisis, is bound to become more of an issue for investors. Below we discuss why liquidity may cause problems for bond investors, particularly in areas where it has been taken for granted, such as ETF's and high yield funds.

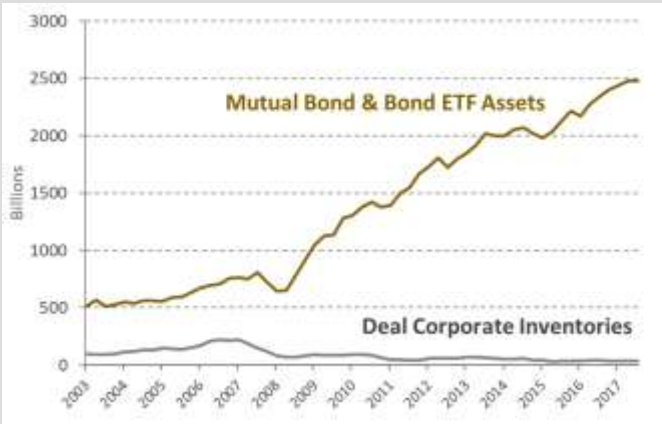
Regulatory developments requiring tighter bank capital and more liquidity coupled with stringent Basel III rules have reduced the intermediation capacity of bank-dealers and forced them to shift their trading model from principal (take positions through inventory) to agency (brokering). (See Figure 3.) Bank-dealers are no longer in position to smooth corporate bond flows by employing their balance sheet. Although corporate bond liquidity is still viable, it has declined significantly since the credit crisis, resulting in a steady increase in bid/ask spreads. In dollar terms, corporate bond trading has steadily increased across all areas, but bond turnover (market value traded / amount outstanding) has decreased, particularly for less liquid lower rated long-term issues (which carry higher risk weights and liquidity charges for bank-dealers). (See Figure 4.) Further complicating matters has been the disproportionate growth of riskier lower-rated longer-dated debt. During the taper tantrum, we witnessed the difficulty markets had dealing with severe corporate bond fund outflows from the riskiest bond funds as bank-dealer balance sheets contracted. Although one could argue that historically banks have not back-stopped the corporate market during dramatic credit events, they had traditionally been actively engaged during major changes in corporate sentiment. We believe that a market event, even of moderate significance, will cause credit spreads to material gap out for lower-rated, infrequently traded corporates.

Figure 3: Corporate Bond > 10-Years Turnover



Source: IIROC, Company Reports, FTSE Russell & Lorica Investment; Sept 2018

Figure 4: US Dealer Inventories to Fund Assets



Source: Bloomberg & Lorica Investment; Sept 2018.