

**Market Highlights**

Government of Canada yields continued their march lower in Q2, albeit at a much slower pace than the decline in the preceding three quarters. Notably, the decline in 2-year Canada yields of 8 bps during the quarter was smaller than that of 5-years at 11 bps, and much smaller than that of 2-year Treasury yields at 54 bps. While US yields outperformed (greater decline) Canadian yields across the short-term yield curve, the outperformance was greater the shorter the maturity (Q2 change in Canada-US yield spread 2, 3 & 5-years: 46, 40 & 35 bps). The large fall in 2-year US yields resulted in a steeper US short-term yield curve (change in 2-5's: 7 bps) versus a flatter Canadian short-term yield curve (change in 2-5's: -5 bps) over the quarter.

The changes in sovereign yield curves indicate a significant divergence between Fed and Bank of Canada expectations. As at quarter-end, futures markets were pricing in a 88% probability of 50 bps or more of easing from the Fed versus only 34% of 25 bps or more from the Bank of Canada by year-end. US economic data has deteriorated quickly, and investors have interpreted the Fed's "body language" as sympathetic to easier policy (no clear forward guidance has been given). In contrast, the Canadian data is more nuanced, given the improvement in energy prices and still-healthy employment gains (other domestic economic data has weakened alongside that of the US), and the Bank of Canada has been steadfast in its willingness to look past weakness. However, the Bank has highlighted risks associated with the trade environment, which may ultimately be the only factor that really matters.

Longer term Canada and Treasury yields continue to be depressed by forces outside of North America. Both the BoJ and the ECB are locked into easy monetary policy. The BoJ's situation has not really changed in years – negative policy rates and QE persist. The ECB however, had just halted bond purchases, but are now talking about both lowering rates and resuming QE. Negative bond yields for Japan and the highest rated European sovereigns (in all but long bonds) is translating into lower NA yields, particularly in the mid and long terms. In Canada, the impact of low global sovereign yields has been particularly felt in the short (2 to 5-year) yield curve which was inverted by 8 bps at quarter-end.

Canadian credit markets fared well during the quarter with short term investment grade corporate yield spreads narrowed by 15 bps. Investment grade credit outperformed similar term high yield bonds as investors showed their willingness to own corporate bonds, but within reason. In general, investors have been extremely tolerant of risky assets – note the rebound in equity prices this year which, to us, suggests a widely-held belief that the Fed will be able to restore consumer confidence and stimulate the domestic economy. However, equity markets may be a little ahead of themselves – forecasting the Fed's response

over the balance of the year may end up being relatively straight forward but forecasting the progression of the trade war and its economic impact is certainly not.

Portfolio Activity

The duration of the portfolio was extended to reflect an increased possibility that the Bank of Canada will eventually have to follow the Fed's lead in lower policy rates.

What Worked In The Quarter

The portfolio was overweight provincial and corporate bonds relative to the benchmark. The sector holdings of each benefitted relative performance as the average yield spreads of the portfolio's provincial and credit holdings tightened by 5 and 21 bps respectively versus 0 and 15 bps for the benchmark.

What Did Not Work In The Quarter

The portfolio was more conservatively structured with a shorter duration and steepening bias relative to the benchmark.

Outlook & Strategy

We still expect the US economy to deliver reasonable growth in 2019. However, the challenging trade environment – we are not hopeful that there will be substantial progress anywhere – and consequent impact on global growth will likely necessitate the Federal Reserve's involvement. We think it likely that the Fed will deliver at least one rate hike this year – although they have generally guided for caution, recent comments suggest they are prepared to act. Canadian growth is vulnerable to weaker exports should energy prices soften, which could easily force the Bank of Canada also into lowering rates.

Real yields should eventually expand in the longer-end of the yield curve, resulting in a steeper overall yield curve. However, negative Japanese and European sovereign yields and resulting foreign flows into North American bond markets will remain a significant factor, depressing longer-term US and Canadian real yields. Finally, we believe that tight labour markets should eventually push inflation expectations higher, but given recent experience, are hesitant to predict the timing of this move.

The environment should remain favorable for domestic investment-grade bonds as supportive monetary policy and durable credit metrics have reduced the risk of a disorderly selloff. However, we feel that the risks remain elevated for more speculative credit classes, given the market's risk tolerance and insufficient capacity of the market to absorb riskier debt outflows, which increases the risk of a repricing cycle becoming self-reinforcing. We remain overweight credit with liquid positions, well-positioned to capitalize on relative value and yield enhancement opportunities.