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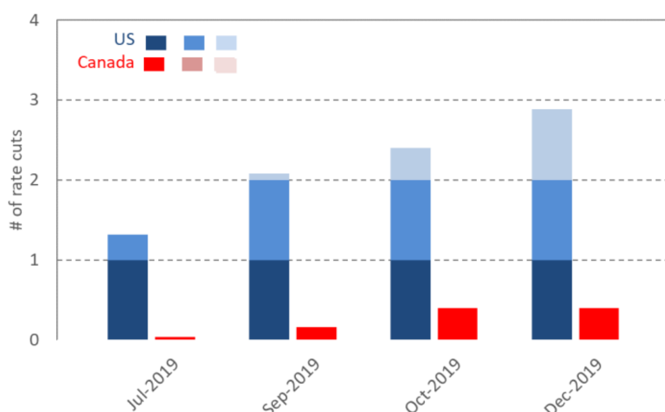
What We Think…

The markets have spoken… While the Fed has been loath to explicitly commit to lower rates – much to President Trump's chagrin – investors have boldly priced in 100% chance of a 25 bps rate cut by the July 31st FOMC meeting and a total of 75 bps by year-end (see Figure 1). This is not to say that the Fed has not left some clues of its predisposition for lower rates, including reworked language in the "no move" statement following the June FOMC meeting and Fed Chair Powell's comments at the post-meeting presser. Perhaps, more visibly, St. Louis Fed President Bullard's dissention and Minneapolis Fed President Kashkari's desire for an immediate 50 bps cut have led investors to believe that there is more support for aggressive *dovish* action inside the Fed than has been communicated.

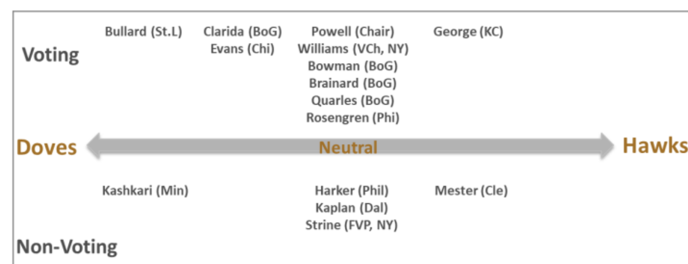
Figure 1: US & Canada Policy Rate Expectations



Source: Bloomberg & Lorica Investment Counsel Inc

Much of the Fed's decision revolves around what's happening to trade. However, the trade situation is not easily diagnosed, as trade data is not entirely relevant (not to mention dated, at the best of times) as it is the politics of trade that matters most. That's not to say that the recent decline in global trade cannot be viewed as a precursor to what may come down the pipeline should the trade environment remain unstable or even deteriorate further. Nevertheless, the overwhelming variable impacting the current outlook for US and Canada trade is the Trump administration, which has been provocative (not necessarily without merit) and generally unpredictable. A change in direction of the US-Chinese negotiations would likely result in an abrupt change to the trade outlook and a similarly abrupt change to the Fed outlook. Notwithstanding the possibility of a surprise outcome from President's Trump and Xi (nothing substantial came out of the G-20 meetings in Osaka) our own expectation is for a continuation of the narrative that has persisted thus far this year. Namely, the US's demand for concessions from China and China's corresponding aversion to substantive concessions.

Figure 2: FOMC Committee – Doves & Hawks



Source: Lorica Investment Counsel Inc.; June 2019

We have been of the opinion that if the US economy slows, the Fed would blink sooner than would the president – we still believe this to be the case; in fact, this is already the case. The president has not given any indication of retreating from his "China" stance, while the Fed has softened its position substantially. We remind readers, that the Fed's mandate is unambiguous – inflation and growth. Entrenched slowing of the economy will necessarily elicit a policy response. In our estimation, the FOMC is leaning dovish – our Doves & Hawks chart likely understates this (see Figure 2). We are confident that President Trump will not be in a hurry to backpedal on trade, especially given the support from his base for the current course of policy. A recent survey by the University of Maryland[*] indicates that amongst Republicans, 77% approve of the US administration imposing tariffs on China without first getting a WTO ruling against China; and when asked what the administration should do in the event that China does

[*] Kull, Steven, I.M. Destler, Evan Fehsenfeld, Evan Charles Lewitus. 2019. Americans on International Trade Policy. *Program for Public Consultation, School of Public Policy, University of Maryland.* 2019 (June): 22.

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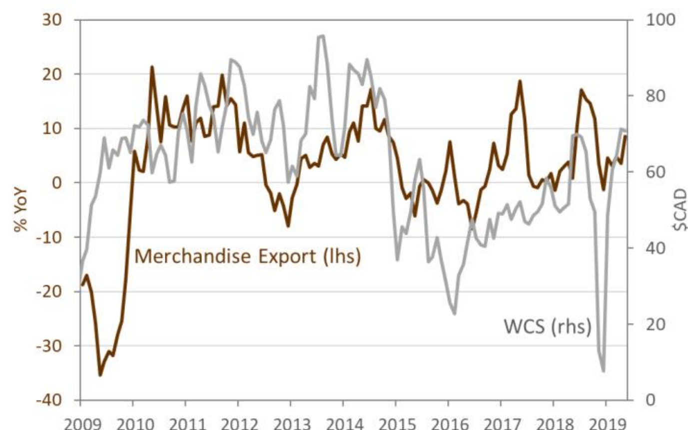
not change its trade practices, 64% would choose to impose additional tariffs without first getting a ruling.

Real-time data series point to a sharp slowing in the US economy and most forward-looking indicators point to a continuation of this trend. We have included a selection of economic indicators which all point to significant declines during the last 3 months. Devotees of the yield curve as a recession forecasting tool, point to the inversion of the 3-month T-bill to 10-year US yield curve – now at 26 bps (inverted), as evidence of an ensuing slowdown and ultimately recession. (The 3-month to 10-year curve has predicted 6 of the 7 recessions over the last 80 years.) Paradoxically, risk-assets are not pricing the same decline, but rather appear to be looking further ahead, incorporating rate relief into valuations, and assuming only a shallow slowdown. US equity indices recently broke record level and corporate yields spreads are not far off their lows since the credit crisis.

If there is no ceasefire in the US-China trade war and the economy continues to deteriorate, we expect the Fed to lower rates by 25 bps at its July meeting, and if the data does not improve by Q4 likely another 25 bps before the end of the year. Clearly, if the economy takes a turn for the worse, we can expect more from the Fed (possibly including QE). Seventy-five basis points of easing by year-end is already priced into short-term rates and as such, our expected amount of easing would not necessarily move markets, unless investors begin to price in more – possible, but not probable, in our view. We feel that 50 bps of easing would be likely be enough to improve confidence and stimulate the domestic economy, but admit the situation is fluid and difficult to predict.

The US economy, for the time-being, is still on “recession watch” given the inversion of the US T-bill to 10-year Treasury curve. However, we have been consistent in stating that the slope of the Treasury curve, which historically has been a good predictor or recession, is not necessarily conforming to historical precedents. Negative rates and quantitative easing in Europe and Japan, has forced those regions’ sovereign yields negative, which in-turn has depressed Treasury yields and contributed to the prior inversion of the Treasury curve.

Figure 3: Canada Merchandise Exports versus Western Canadian Select Prices



Source: Canadian Association of Petroleum Producers, Statistics Canada & Lorica Investment Counsel Inc.; May 2019

For much of the period since the credit crisis, the Canadian and US economies have been out of sync, largely due to the large influence of energy exports on the Canadian economy. During the most recent monetary tightening cycle by the Fed, the Bank of Canada lagged considerably, a reflection of weak Western Canadian Select (WCS) prices (see Figure 3) – the product of lower energy prices globally, and the unique challenges faced by Canadian producers to bring product to market. We are again looking at a scenario where the two economies appear out-of-sync. The US economy is evidently decelerating while Canadian economy, on the surface, has been relatively resilient. The recent strength of WCS prices – reflecting a rebound in global energy prices has contributed to Canada’s improved trade balance. However, beyond trade, the domestic economy appears more vulnerable, tracking trends seen south of the border.

Looking at Figures 4, 5 and 6, it is apparent that domestic factors contributing to growth in the US and Canadian economies, e.g. retail sales, housing and manufacturing, have tended to be fairly correlated; whereas trade has tended to be less so. Given on one-hand the dependence on energy prices for the current bout strength for Canadian exports and, in turn, the Canadian economy,

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Figure 4: Canada & US Retail Sales

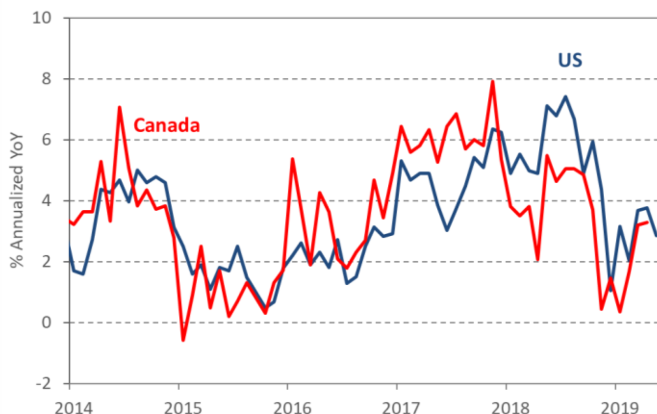

Figure 5: Canada & US Existing Home Sales

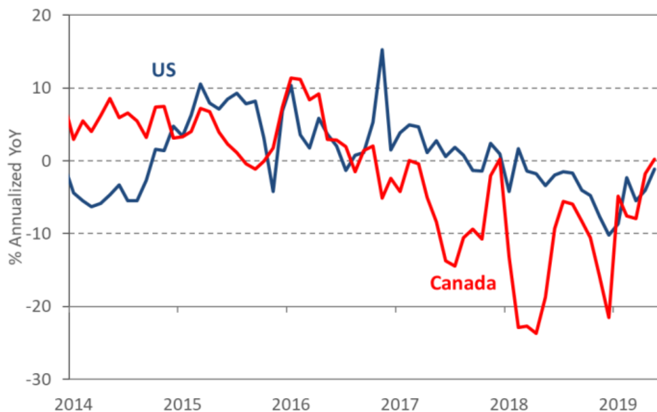

Figure 6: Canada & US Manufacturing Purchasing Managers Index

Source: Bloomberg & Lorica Investment Counsel Inc.; June 2019

and, on the other-hand the slowing elsewhere in the domestic economy, it is difficult to remain too confident that overall Canadian growth will significantly outperform US growth over the medium term. It is difficult to say with any confidence that energy prices will remain elevated. (Here again the Trump administration is having a direct impact with OPEC supplies constrained via US sanctions on Iran.) Should energy prices decline with more supply coming on stream and/or slowing of the global economy, the Canadian economy ultimately faces many of the same domestic issues hampering the US economy.

Canadian markets are now pricing in a 35% likelihood of an ease by year-end which we feel could easily change, with a decline in energy prices. The Bank of Canada has tended to look past temporary weakness, while being careful to point out economic risks, largely related to trade uncertainty. Should exports falter (i.e. oil exports) and the Fed ease, we anticipate the Bank of Canada will eventually have to follow suit, notwithstanding Canadian overnight rates are already very low and at a discount to US overnight rates. We think the domestic economy just looks too vulnerable given the slowing south of the border. We expect investors would be quick to pick this up, causing the front-end of the yield curve to outperform the back-end – i.e. yield curve steepening. The Canada 2 to 10-year yield curve is essentially flat, with inversion from 2 to 7-years. We think investors will normalise the slope of the curve, with the caveat that, as with the US yield curve, there are significant technical factors (i.e. negative sovereign yields elsewhere) affecting the slope, thus rendering it unreliable in an historical context. We would also add, that we do not foresee an imminent change in monetary policy direction from either the BoJ or the ECB, which should keep downward pressure on longer-term NA yields.

The Canadian dollar is valued at 0.765 cents US which is about 5 cents below its long-run "floating exchange rate regime" average (since 1970) of 0.82 cents. Despite WCS having increased by $30 to June 30th from the low of $13.46 in November 2018 (Bloomberg), the appreciation of the loonie has been only 3 cents, limited by the

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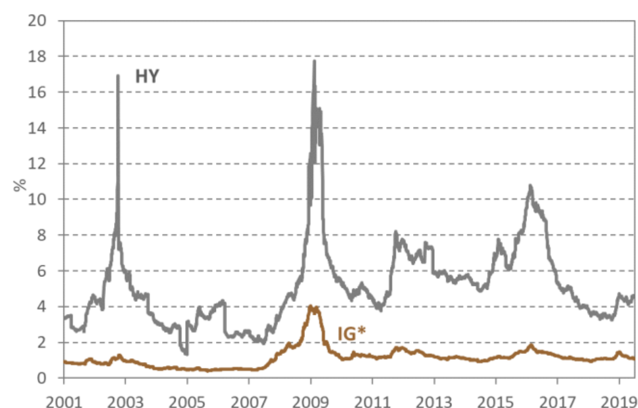
widening gap between US and Canadian overnight rates which has gone from 25 to 50 bps over that time. At the beginning of BoC Chair Poloz's tenure, it appeared (though not explicit) that the Bank had an obsession with having a weaker dollar to help stimulate exports. The C$ eventually weakened, but exports did not convincingly surge, owing to other underlying factors, culminating with anti-trade sentiments emerging from the US. While we think the bank still prefers a weaker currency, we feel it is no longer viewed as the saviour it once was. However, should the Fed lower rates, monetary conditions would tighten so long as the bank holds pat and the C$ appreciates.

We had lengthened the duration of our core portfolios in the spring with the view that trade and trade uncertainty would be the biggest drivers of yields this year - global yields have declined this year. We have been reluctant to extend duration to that of the benchmark noting our ongoing concern with the length of the benchmark duration – the modified duration of FTSE Canada Universe Bond Index is now over 8 years. Our portfolios are still positioned with long durations, in absolute terms, and for a steeper yield curve.

Corporate bonds have performed well despite economic concerns emerging from many directions. Evidently, investors have faith that the Fed will once again come to the rescue of risky assets through lower rates and perhaps quantitative easing. That is not to say that Canadian bond investors have not shown a preference for higher grade assets, as can be seen by the yield spreads between investment grade and high yield bonds in Figure 7. Canadian corporate bonds have faired particularly well year-to-date as the concentration of high-quality issuers together with a captive investor base has combined to narrow spreads in the face of deteriorating economic sentiment. Lower-rated and longer-term corporates have underperformed on a spread basis, albeit both have done well on an absolute basis given spread narrowing and the decline in Government of Canada yields.

Figure 7: Canada Investment Grade & High Yield Spreads



**The Index is comprised of 50% FTSE Canada Short-Term Overall Bond Index & 50% FTSE Canada Mid-Term Overall Bond Index*

Source: FTSE Russell & Lorica Investment Counsel Inc.; June 2019

The dissonance between sovereign markets and risk assets definitely warrants some level of concern for investors. The most likely economic scenario is, in our view: a soft landing, where modest easier monetary policy kickstarts the economy – this seems to be embedded in market expectations. A better-case scenario, but less likely, is: a truce between China and the US, which would see the global economy gain better footing, and relax the need for aggressive monetary policy. The worst-case scenario is: no cessation in US-China trade hostilities (too much at stake, including egos), deterioration in economic fundamentals (too much negative momentum), and inadequate firepower on behalf of central banks. The US overnight rate at 2.25% to 2.5% is still below what had been the (much reduced) target level of Fed rate normalization – 2.5%; and the Fed's target balance sheet runoff is not complete. Both monetary policies are central to the Fed's arsenal, and suggest the Fed has less ammunition than what it needs to feel comfortable. Not to mention the BoJ and ECB, both of which are holding policy rates negative, and one of which is mired in QE while the other flirts with resuming it.

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