

## Short-Term Bond

January 2020

### Market Highlights

That was certainly one of the more eventful January's in recent memory... so much for being able to focus on those New Year's resolutions. Australian wildfires, a downed Ukrainian Airline plane, US-China trade deal, US-Mexico-Canada trade deal, the Coronavirus, the Trump impeachment trial, Brexit, and yes Megxit. The first month of the new decade was certainly no slouch in the news department. From a market perspective, the news was not benign – the optimism that should have grown considering the relatively strong economic data was instead overshadowed by the pessimism surrounding the news.

In the US, equity markets were essentially flat at  $-0.04\%$  (S&P 500 Index) while the bond market was up  $1.92\%$  (Bloomberg Barclays US Aggregate). In Canada, equities were up  $1.74\%$  (S&P/TSX) due to good broad-based performance with the notable exception of the energy sector which grossly underperformed on the back of falling energy prices. The Canadian bond market produced superlative returns of  $2.91\%$  (FTSE Canada Universe Bond Index), outperforming its US counterpart due, in large part, to the materially longer duration of the Universe Index compared to the Aggregate Index. The Short Term Overall Bond Index returned  $1.04\%$  for the month.

News was not the only driving factor for the bond market, however. The Federal Reserve's term repo operations (quantitative easing in all but name) were ramped up in late December to protect against a potential cash crunch at year-end. The Fed was nervous of a repeat of the spike in interest rates that took place in September which precipitated the Fed's repo operations in the first place. In December, the Fed announced it would bump up the limit on its repo operations from \$120 Billion to \$150 Billion for Dec. 31 and Jan 2. The Fed subsequently reduced the limit to \$35 Billion and extended the operations through mid-February. Perhaps not surprisingly, the excess liquidity that has been injected into the monetary system has coincided with January's significant rally in the bond market.

Both the US Treasury and Government of Canada short term yield curves flattened in January as 5-year yields declined by 37 and 39 basis points, respectively, while the decline in 2-years yields was limited to 23 and 26 bps, respectively. Both the Fed and the Bank of Canada indicated that they were inclined to leave rates unchanged and would be monitoring the environment closely. While the US yield curve has shown signs of steepening, albeit punctuated by periods of flattening amidst so much market uncertainty, the short-term Canadian yield curve remains very flat with the 2's-5 inverted at  $-14$  bps as of January-end. The more significant cracks appearing in the Canadian economy coupled with foreign flows into the bond market continue to apply pressure to mid and longer-term yields.

Canadian corporate spreads were volatile during the month, initially responding to better economic data and supportive monetary policy, and then succumbing to the uncertainty, fear and ultimately, economic impact of the Coronavirus. Canadian corporates outperformed US corporates due to the concentration of higher-rated domestic-centric issues and little exposure to commodities and energy producers.

### Outlook & Strategy

We still expect the US and Canadian economies to ultimately deliver reasonable growth in 2020. However, we are going through a period of major uncertainty related to the unusually large number of non-homogenous shocks to the global economy. But low unemployment rates and ample wage growth will continue to fuel domestic consumption and growth. The hostile and unpredictable trade environment – we are still skeptical that there will be substantial progress between the US and China, Phase 1 notwithstanding – and consequent impact on global growth will likely necessitate continued accommodative monetary policy from central banks. We think it possible that the Fed and Bank of Canada each deliver another rate cut over the course of the year – but both will be reluctant to make such a move.

Long-term real yields should eventually expand, 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 both long-term US and Canadian real yields. Finally, we believe that tight labour markets should eventually push inflation expectations higher but recognize that there are significant structural factors that may continue to delay such a 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.

There are many uncertainties that will have to be accounted for this year, but our baseline scenario is that the US and Canadian economies will not be derailed. In Canada, the minority government will face its challenges, but we do not expect to see any real attempt to unseat the liberals this year. In the US, the impeachment has given way to the democratic nomination, and we expect to see US-trade fade into the background ahead of the November presidential election. In Europe, Brexit could lead to trade confrontation between Great Britain and the continent, as well as precipitating nationalist sentiments in Scotland and Northern Ireland. Finally, in Asia, China's ambitions to be the dominant power, will take a backseat until the Coronavirus has been tamed.