

Short-Term Bond

April 2020

Market Highlights

It has been roughly two months since large parts of the global economy have been shutdown and predictably the data is painting a pretty horrid picture. High frequency data such as US jobless claims have been the quickest to show the tragic collapse of employment as many service sector jobs have disappeared to lockdowns. However, jobless claims mask the true decline of work as many employers have opted to retain employees with the aid of government subsidies, despite those employees being underemployed due to the fall-off in demand. Over time, as the economy gradually opens up, some laid-off employees will go back to work, while others may find themselves newly unemployed as their employer eventually reacts to stunted demand and the ending of government subsidies.

With such an abrupt halt to economic growth, with so much uncertainty surrounding the virus and with such unprecedented government intervention, it will take time for economic data to catch up with the changes that are taking place. In the short-term, the data will not be overly helpful in predicting the path for the economy. Furthermore, bond market data, which, in our view, has long been distorted by so much policy intervention, is many times more-so distorted today – with so much QE and in so many sectors – and will not be a very reliable indicator of investor sentiment surrounding the economy.

Nevertheless, April saw bond prices respond significantly to central bank intervention, as investors reassessed the prospect for credit despite weakened fundamentals. Both the Federal Reserve and the Bank of Canada announced QE programs to provide liquidity to credit markets. In turn, credit spreads narrowed abruptly from panic-driven levels. In the US, the most notable development was the Fed's inclusion of high yield bonds in its QE program, while in Canada, the inclusion of provincial and, to a lesser degree, corporate bonds in the BoC's program was market moving.

In April, the Short Index returned 1.33%, led by corporates at 2.41%, followed by provincials at 1.27%, and then Canada's at 0.53%. The strong credit performance in April was just a rebound from the terrible performance in March, leaving the sector performance for the year-to-date for Canada's, provincials and corporates at 3.78%, 3.85% and 1.79% respectively; the Universe returned 3.20%. While, by April-end, provincials had recouped a significant portion of this year's peak (March 26th) spread widening: narrowing 25 bps on 41 bps of widening, corporates had lagged: narrowing 86 on 185 bps of widening (both for short-term bonds).

Outlook & Strategy

The future of the virus and the economy are as unclear as they are inextricably linked. While lockdowns the world-over have followed a general pattern (with some obvious exceptions): from the removal of household liberties such as grocery shopping and exercise in democracies to state controlled provisioning for food and services in authoritarian regimes. In most cases lockdowns were guided by a uniform stance amongst experts that intensified as the transmission of the virus increased. The same will not be said for "opening-up" which will vary substantially in implementation and timing from place-to-place – a function of politics, economics and science. It remains to be seen what is in store for the economy: will test and trace be able to limit the inevitable rise in cases or will hospitals be overrun leading to eventual re-lockdown?

In the meantime, we don't expect the economy will emerge quickly from recession. Already weak household (particularly acute in Canada) and business balance sheets have been severely damaged by the loss of income. Economies will not be able to rely on consumer spending (capital spending has long been diminished) to respond to stimulative monetary policies. Despite government support of households through subsidies and EI, we expect consumers to respond to the uncertainty, rise of unemployment, reduced opportunity and motivation for spending, and weakened finances by increasing their savings. This could very well represent a secular shift in household behaviour.

Through this period of uncertainty and recession, we expect bond yields to remain low. It is unlikely that US or Canadian policy rates will go negative, but they will stay near zero. Yields further out the curve will be anchored by stable short rates and low inflation – we do not expect the increase in money supply to be inflationary until well into the future. For now, both the US and Canada are employing QE to stabilize yields and credit spreads. However, we would not be surprised to see, at some point down the road, QE used to flatten the yield curve into the long end. The Government of Canada overnight-10's yield curve is now 37 bps, while the 10-30's yield curve is 55 bps.

We had extended the duration of the portfolio in April through the purchase of longer provincial bonds. We are comfortable owning provincial and short-term corporate bonds given the explicit market support from the Bank of Canada through its QE program, despite the deterioration in credit fundamentals.