Short-Term Bond

July 2020

Market Highlights

Bond yields trended slightly lower during July as the realities of a protracted recession continued to sink in. With monetary policy already at ZIRP (zero interest rate policy) and negative rate policy unlikely (for the time being), short-term bond yields have stabilized around policy rates. However, two-year Canada yields did manage to fall a couple of basis points to end July at 0.28%. Five-year Canada yields fell by 5 bps, to end the month at 0.32%. While Canada yields followed the move in US Treasury yields over the month, the decline Treasuries was more pronounced further out the curve – 5-years fell by 8 bps. By the end of July, the Canadian short-term yield curve was still flatter than the Treasury curve with the Canada 2-5's curve at 5.5 bps versus 8.5 bps for the comparable Treasury curve. The disparity in the 2-30's Canada and US curves is more distinct at 70 and 125 bps, respectively.

The difference in US and Canadian yield curves does not necessarily represent worse expectations for the Canadian economy. Although, the Canadian economy has been under pressure from weak energy markets and disappointing capital investment, both Canadian and US economies are facing significant economic headwinds. Unemployment in both countries is running over 10%, and both countries are dealing with the pandemic. Canada's situation is generally far more under control than in the US, with the deep political divide that has permeated handling of the virus largely absent in Canada. Although the US was quicker to open parts of its economy during Q2 – with immediate economic impact – this largely back-fired with "re-lockdowns" necessary in many of the most populated states.

Both the Fed and the Bank of Canada have been actively engaged in bond market purchases, which have included maturities over 10-years, so it is not immediately obvious that this is a strong factor affecting the relative performance of long bonds. In addition, although the US typically benefits from a flight to safety bid and Canada's lower yields should not support strong foreign investment, purchases by foreigners have been strong since April. The US curve offers more value and we would not be surprised to see the two curves come more into line over time.

Credit spreads narrowed and the credit curve steepened in July, as the sound environment for credit continued with generally positive risk sentiment and moderate primary issuance overwhelming a mixed start to Q2 earnings season. Spreads tightened by an average of 20 basis points over the month, with short and mid-term higher-beta issues outperforming. Concerns over BBB-rated credit with negative outlooks subsided, notwithstanding global potential downgrades reaching their all-time high.

Outlook & Strategy

The future of the virus and the economy remain unclear as they are inextricably linked. The resurgence of the virus in many parts of the US where opening-up appears to have been premature is indication that returning to normalcy too quickly is fraught with risks and failure. Although the markets suggest that many were quick to extrapolate the early economic success of opening-up, public policy reversals in many US states imply that this optimism is unwarranted. The Canadian economy has been hard hit, and cautious opening-up, while likely beneficial in the long-run, will not alleviate the problems in the short-run. The evidence, so far, leads us to believe that broader economic recovery will rest heavily on the success of a vaccine or game-changing treatment, neither of which appear to be imminent.

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. The economy will not be able to rely on consumer spending (capital spending has long been diminished) to respond to stimulative monetary policy. Despite government support of households through subsidies and EI, we expect consumers will respond to the uncertainty, rise of unemployment, reduced opportunity and desire for expenditure, and weakened finances by saving. This could very well represent a secular shift in household behaviour.

Through this period of uncertainty and recession, bond yields will remain low. We do not expect either US or Canadian policy rates will fall 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 countries are employing QE to stabilise yields and credit spreads. However, expect to see, at some point down the road, QE used to further flatten the yield curve into the long end.