

Short-Term Bond

May 2020

Market Highlights

For many of us, we are living in the most tumultuous economic time of our lives. However, glancing at capital markets, this would not be immediately obvious. The bond market has largely been insulated from the economy by central bank intervention and equity markets appear to be looking well beyond job losses and business failures. But we would caution using the capital markets as a reasonable estimate of what lays ahead. The bond market does not function as a reasonable mechanism of price discovery and equity markets are being propped up by so much government support.

The collapse of the economy is easily the worst since the great depression with job losses expected to result in unemployment rates of 15% and 20% for Canada and the US, respectively (according to Bloomberg consensus forecast) – and that is with significant government support to retain employees. It remains to be seen how the counteracting effects of heading back to work and the eventual end of government subsidies will impact these unemployment rates. Nevertheless, such high levels of unemployment, represents a deep hole in the economy, that combined with leveraged households will result in weak domestic growth. The global nature of the pandemic and ongoing trade conflicts will ensure that non-domestic related growth will also be weak. The economic forecasts for Q2 are too awful to quote, but even after some rebound the calendar year 2020 forecasts are also weak with the median estimates for Canada at -7% and the US at -5.7% for real yoy GDP growth.

It is anyone's guess what the consequences of social unrest in the US will mean for the US economy and by extension the Canadian economy. Commentators have highlighted the problems of class inequality in the US for a long time, racial inequality is directly related; and the US election is only five months away, whose outcome is still difficult to predict. However, it is reasonable to assume that between now and then, there will be continued uncertainty related to a host of factors including the epidemic, unemployment, government and central bank intervention, social unrest, and China.

Despite all the problems, the US and Canadian bond markets just plod along. The Fed and the Bank of Canada have pledged to support the legion of borrowers, be-it government or corporate, AAA or high yield (albeit, not in Canada). Yields are in somewhat of a holding pattern but yield spreads have narrowed. Underlying credit quality has deteriorated but any investor concerns have been easily offset by the artificial demand created through central bank quantitative easing. For now, the goal has been to facilitate financing and trading while keeping yields relatively stable – government yields have responded in kind, and credit spreads, after the initial hiccup wider, have rebounded to “non-panic” levels. Short-term Government of Canada yields traded within a maximum 7 basis point range along the yield curve during May while corporate yield spreads narrowed by an average of 9 bps.

Outlook & Strategy

The future of the virus and the economy remain unclear as they are inextricably linked. Lockdowns the world-over are now mostly in various phases of removal: from resumption of non-essential work to the opening of restaurant dine-in and fitness clubs. In most cases lockdowns were guided by a uniform stance amongst experts but intensified as the transmission of the virus increased. The same cannot be said for “opening-up” which varies from place-to-place – a function of economics, politics and science. It remains to be seen what is in store for the economy: will test and trace be able to keep pace with probable subsequent waves or will hospitals be overrun leading to an 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. The economy will not be able to rely on consumer spending (capital spending has long been diminished) to respond to monetary stimulus. 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, we expect bond yields to remain low. We do not expect either US or Canadian policy rates will fall to negative, but 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 support 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 of the yield curve. In Canada, the government 2-5's, 5-10's and 10-30's yield curves are now 16, 19 and 60 bps, respectively.

We feel that highly rated, liquid, short and mid-term corporates are attractive on both an absolute and relative value basis. Although long-term credit is less attractive on a relative value basis, we are also cognizant of the fact that central banks may eventually flatten yield curves, thus driving down overall long-term credit yields.