

Market Highlights

While the overall Canadian bond market had its worst month since March 1994, as longer-term yields backed up and the yield curve steepened, the short-term bond market had its worst month since only June 2017: -0.80% (FTSE Russell Canada Short Term Bond Index). Two-year Canada yields rose by only 15 bps (subsequent to month-end 2-year yields have fallen by 6 bps as of writing), while 5, 10 and 30-year yields rose by 45, 51 and 28 basis points, respectively. Two-year Treasury yields rose by only 2 bps, while the backup in longer US Treasuries was more even with 5, 10 and 30-years yields rising by 31, 34 and 32 bps, respectively.

The backup in longer-term yields was precipitated by good news on the vaccine front and expectations related to the Biden stimulus package – the two combined to prompt investors to raise real yields: 10-year US real yields rose from -1.04% to -0.74%. Although the Canadian economy clearly has more challenges on the vaccine front leading to an expected lag to the US in “opening up”, the Canadian bond market is being dragged along by the US: 10-year Canadian real yields rose from -0.70% to -0.44%. It is notable that much of the discussion surrounding the sell-off has been about rising inflation expectations, however the Fed’s favourite barometer of expectations – the 5-Year, 5-Year Forward Inflation Expectation Rate – actually fell by 14 bps during the month.

The relative stability of short-term yields is consistent with central bank messaging. The Fed has not provided any evidence that it is about to raise rates or curtail quantitative easing policies. In a recent speech Chair Powell stated: “... *In addition, we will continue to increase our holdings of Treasury securities and agency mortgage-backed securities at least at their current pace until substantial further progress has been made toward our goals.*” The goals he was referring to are maximum employment (“... *shortfalls of employment from its maximum level ...*”) and inflation that averages above 2 per cent (“... *following periods when inflation has been running below 2 percent ... aim to achieve inflation moderately above 2 percent for some time ...*”). For its part, the Bank of Canada, will likely adjust its QE program (increase average maturity) to account for the problematic trend towards its majority ownership of benchmark issues and the fact that its purchases may not be as material to the direction of Canadian bond yields as hoped.

Risk assets continued their strong performance, with investors emboldened by supportive monetary policy and anticipated fiscal stimulus. Corporate bonds outperformed governments. In Canada, long corporates were the best relative performers, with the credit curve flattening against the steepening Canada curve. The provincial curve also flattened, leading to provincial outperformance against Canada’s in the long-end.

Outlook & Strategy

As we move further into the vaccination phase of the pandemic, vaccines and their distribution, together with the spread of variants and effectiveness of policy response, are becoming the most important factors affecting the economic outlook. We still believe that until the virus is well and truly gone, we should expect the unexpected. Still, vaccines promise an end to the pandemic, with the road to that end bumpy and uncertain, as waves of the pandemic and lockdowns will likely persist until vaccinations are truly widespread and herd immunity has been achieved. Capital markets suggest investor optimism of rapid success in 2021 – we are hopeful but doubt that the consensus GDP forecasts will be achieved.

More contagious mutations of the virus are making it difficult for western economies to open-up, which is likely to still be a problem in Q2. Countries will have vastly dissimilar outlooks, as vaccine supplies will remain scarce for some time. In the US, vaccinations should permit more economic activity by mid-year, while Canada will unfortunately lag due to no domestic vaccine manufacturing capacity. Europe’s economies will also lag given the generally poor vaccination rollouts across many countries.

Recent data shows economic weakness, and although we expect improvement, we think that it will be uneven, and economies will be dependent upon policy support for some time. Fiscal policy, while robust now, should not be expected to be maintained at the same level, suggesting monetary policy will continue to be relied upon. The yield curve appears to be signalling a more optimistic view – we think the steepening move is overdone. We don’t expect central banks to raise rates for some time and we don’t expect yield curves to remain steep without some hint of monetary tightening – none is forthcoming from the Fed or the BoC. We expect flattening of the US yield curve to lead to flattening of the Canadian yield curve.

Through the pandemic the credit markets have benefitted from the lowering of sovereign yields and central bank commitments to maintain easy monetary policy and market liquidity. However, there is still the question as to whether excess liquidity can solve persistent challenging economic fundamentals, weak credit metrics, and ultimately, solvency. In the domestic market, which is dominated by investment grade credits, leverage metrics remain elevated, but debt servicing is healthy and refinancing risks are not a near-term threat, even amongst the lowest rated names.