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INVESTMENT RESEARCH

Monthly Fixed Income Update

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Interest Rate Summary	29-Mar18	29-Dec-17	30-Dec-16	31-Dec-15	31-Dec-14	31-Dec-13	31-Dec-12
U.S.							
3-Month T-Bill	1.71%	1.38%	0.50%	0.16%	0.04%	0.07%	0.04%
2-Year Treasury	2.27%	1.89%	1.19%	1.31%	0.47%	0.38%	0.25%
10-Year Treasury	2.74%	2.41%	2.44%	2.27%	2.17%	3.03%	1.76%
Canada							
3-Month T-Bill	1.15%	1.05%	0.45%	0.51%	0.90%	0.92%	0.92%
2-Year Canada	1.77%	1.69%	0.74%	0.48%	0.99%	1.14%	1.14%
10-Year Canada	2.09%	2.04%	1.72%	1.39%	1.86%	2.76%	1.80%

Performance

	Mar-2018	2017	2016	2015	2014	2013	2012
DEX Universe Bond Index	0.75%	2.52%	3.52%	3.52%	8.79%	-1.19%	2.65%
DEX Federal Bond Index	0.75%	0.13%	3.66%	3.66%	6.91%	-1.52%	2.11%
DEX Provincial Bond Index	0.96%	4.33%	4.14%	4.14%	12.18%	-2.70%	
DEX All Corporate Index	0.51%	3.38%	2.71%	2.71%	7.58%	0.84%	6.22%
DEX "A" Corporate Index	0.61%	4. 42%	2.62%	2.62%	9.10%	-0.16%	6.85%
DEX Real Return Bonds	1.49%	0.72%	2.79%	2.79%	13.18%	-13.1%	
DEX High Yield Bonds	n.a.	9.94%					

Comments:

Performance was positive in most sectors of the bond market in March. It was notable that government bonds outperformed corporate bonds by a healthy margin as credit spreads widened.

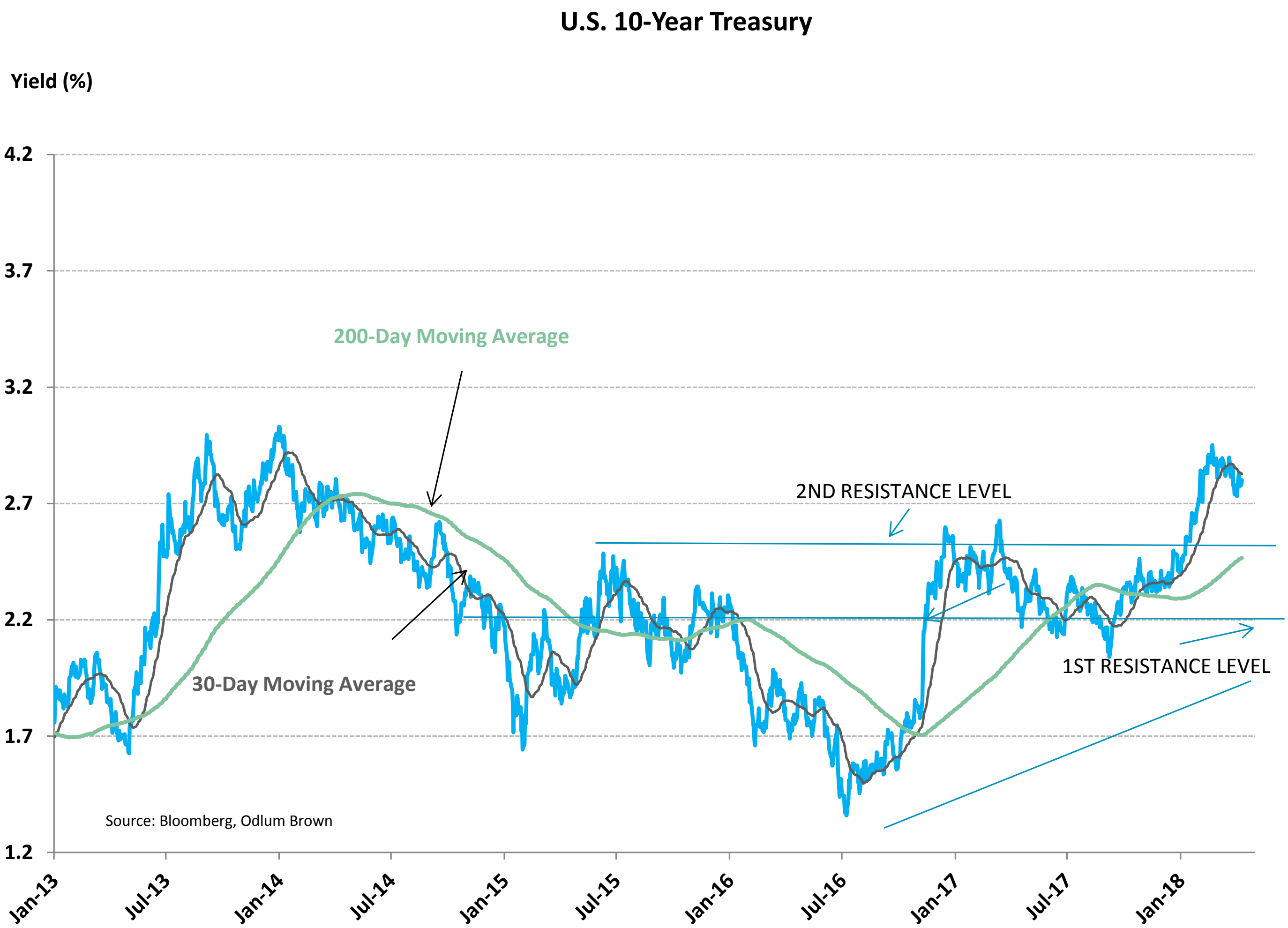
The yield curve flattened further as ten-year yields in the U.S. fell by twelve basis points while two-year yields rose by one basis point. The Canadian yield curve flattened by a similar amount.

The trend to higher bond yields was interrupted in March. Most of the fundamentals pointing towards higher short-term interest rates and bond yields remained in place; namely, buoyant labour markets, strong consumer confidence and spending, strengthening industrial production, firming inflation and increased supply of bonds. However, bond yields, as measured by the ten-year U.S. note, fell by a net twelve basis points to 2.74 at month-end.

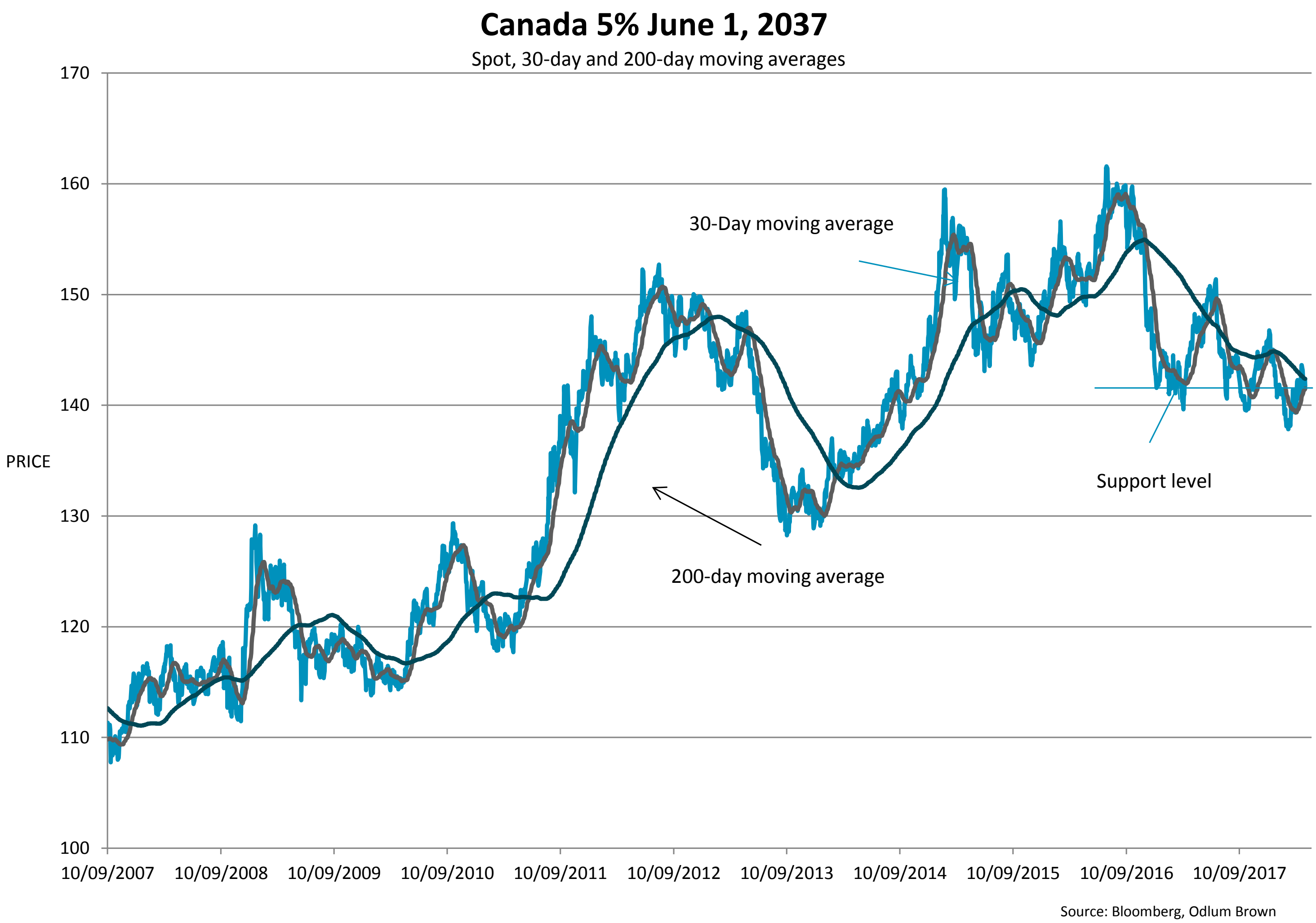
A surprise announcement by the U.S. to impose tariffs on steel and aluminum imports sent markets reeling as it raised the specter of weaker growth and higher inflation. One estimate (BMO Capital Economics) has the CPI being 0.2% higher than it would be otherwise.

The Federal Reserve raised the Fed Funds Rate by another twenty-five basis points to 1.75%. Fed Chairman Powell, in the aftermath of his first FOMC meeting, was not hawkish, which reduced the odds of four hikes in short-term rates this year.

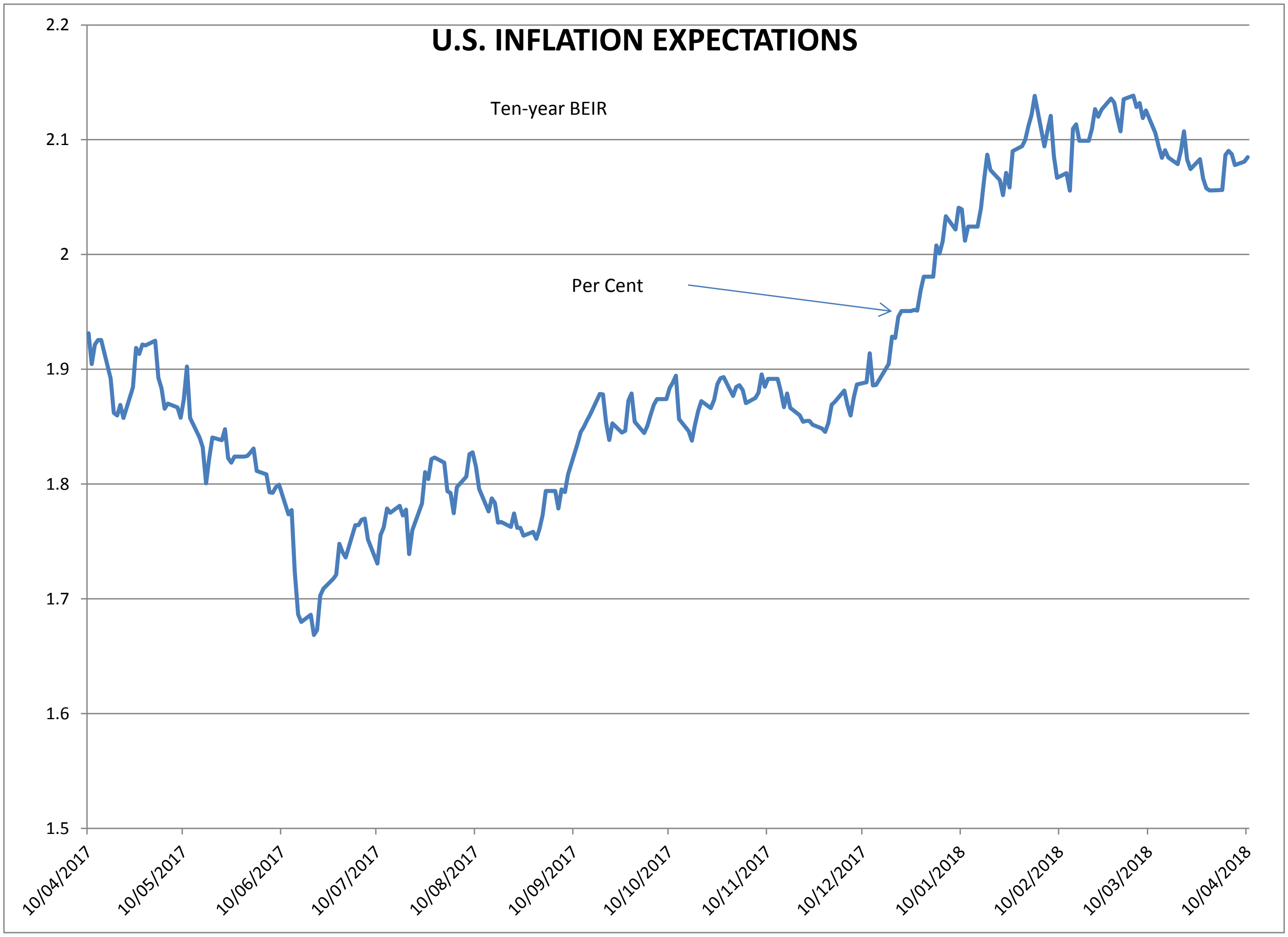
As for Canada, the bloom has come off our economic picture. The housing market has weakened from record levels, export growth has been sluggish and business investment has been weak. Thus, the Bank of Canada moved to a cautious stance and will likely stay on the sidelines until July. The loonie slid sharply early in the month but rebounded towards the end on NAFTA hopes, an uptick in inflation and a steady increase in energy prices.



The yield on this bellwether bond has stabilized just below the psychologically important 3% level. The support level is at 2.63%.

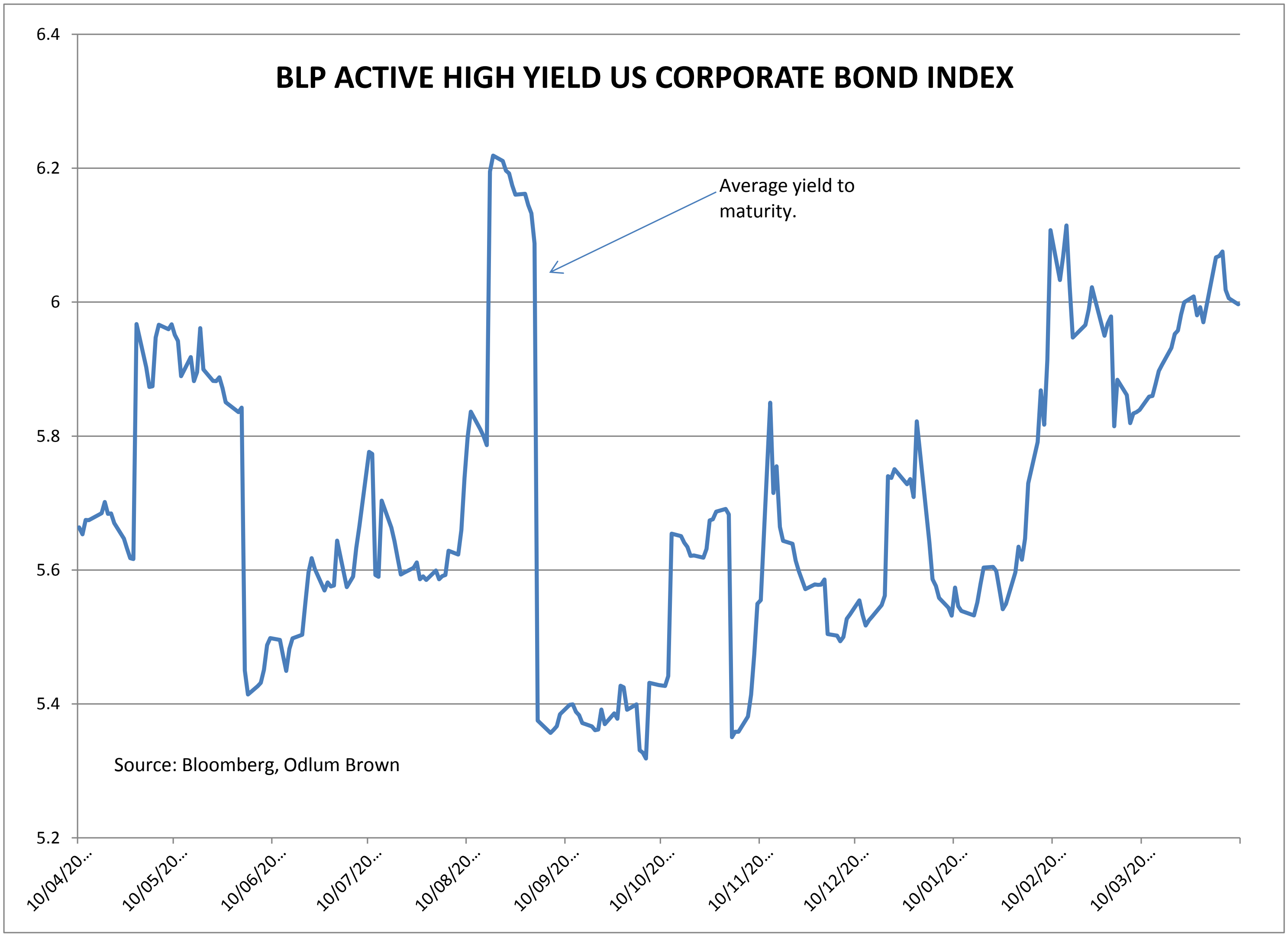


The price of this long-term Canada bond rallied in the past month and is at the major resistance line.



Source: Bloomberg, Odlum Brown

Inflation expectations eased slightly but remain above 2%.



The high yield market stabilized near its high yield mark for the year. Spreads widened as U.S. Treasury yields declined.

Outlook

We maintain our view that the trend towards higher short-term and long-term yields remains in place.

In the near term, bond yields have entered a trading range bound by 2.63% and 3% for the U.S. ten-year note. Ultimately, the ten-year yield should reach 3.25% this year. The Federal Reserve will likely continue to normalize short-term interest rates unless there is a dramatic change in economic conditions.

The Bank of Canada is on the sidelines for now but it maintains an upbeat forecast for our economy. The consensus indicates that the Bank of Canada may not raise its overnight rate until its July meeting.

In the short term, markets have been roiled by the various tariff headlines with the net result being a flight by investors to the safe haven of the U.S. Treasury market. While there has been no noticeable deterioration in economic conditions, there has been some erosion in consumer and corporate confidence. Also contributing to the recent decline in U.S. bond yields has been lower bond yields in Europe where recent data have been weaker than consensus. The result is that U.S. yields looked relatively more attractive. Credit markets also reacted with some widening of yield spreads over government bonds.

Overall, global economic conditions are buoyant and inflation has ticked up. Labour markets are firm and wages are beginning to firm.

Strategy

Against this backdrop, it is difficult to foresee anything but modest to negative returns in fixed income portfolios. At the core of bond portfolios, we counsel fixed income investors to have high-quality, short-duration corporate bonds. This core could be augmented by a representation in the high yield market, as even with the expected rise in government yields, their total returns should still exceed returns from the government sector. At present, the credit markets are showing some signs of strain but yield spreads remain relatively narrow. Should there be more weakness in credit markets, we may advise including selected provincial bonds in clients' portfolios. There is a case to be made for selected investment in funds of certain investment management firms. We endorse a number of those that have added value to clients' portfolios. For more information, please speak to your advisor.
