Monthly Fixed Income Update

Hank Cunningham **August 9, 2017**

Interest Rate Summary	31-Jul-17	30-Dec-16	31-Dec-15	31-Dec-14	31-Dec-13	31-Dec-12
U.S.						
3-Month T-Bill	1.08%	0.50%	0.16%	0.04%	0.07%	0.04%
2-Year Treasury	1.35%	1.19%	1.31%	0.47%	0.38%	0.25%
10-Year Treasury	2.30%	2.44%	2.27%	2.17%	3.03%	1.76%
Canada						
3-Month T-Bill	0.73%	0.45%	0.51%	0.90%	0.92%	0.92%
2-Year Canada	1.31%	0.74%	0.48%	0.99%	1.14%	1.14%
10-Year Canada	2.05%	1.72%	1.39%	1.86%	2.76%	1.80%

Performance

	July-2017	Year-to-Date	2016	2015	2014	2013	2012
DEX Universe Bond Index	-1.90%	0.42%	3.52%	3.52%	8.79%	-1.19%	2.65%
DEX Federal Bond Index	-1.00%	-0.49%	3.66%	3.66%	6.91%	-1.52%	2.11%
DEX Provincial Bond Index	-2.62%	0.89%	4.14%	4.14%	12.18%	-2.70%	
DEX All Corporate Index	-1.38%	1.45%	2.71%	2.71%	7.58%	0.84%	6.22%
DEX "A" Corporate Index	-1.72%	2.16%	2.62%	2.62%	9.10%	-0.16%	6.85%
DEX Real Return Bonds	-3.24%	-3.17%	2.79%	2.79%	13.18%	-13.1%	
DEX High Yield Bonds	0.62%	5.61%					

Comments:

Performance was negative in all sectors of the bond market in July save for the high yield sector. Corporates outperformed Governments while real return bonds sagged noticeably.

The U.S. ten-year note finished the month virtually unchanged at 2.30%, after touching 2.40% mid-month. Since month-end, yields have continued to move down as they are currently at 2.22%. The yield on the two-year note fell by three basis points, contributing to a modest shrinking of the twos-tens spread to 95 basis points from an intra-month high of 99 basis points.

Canada experienced a sharper increase in bond yields. Five year Canadas rose by a further 25 basis points after rising by 50 basis points in June and were at 1.65% at month-end. Ten-year yields rose by an additional 30 basis points to 2.05% after moving up 34 basis points in June.

What happened?

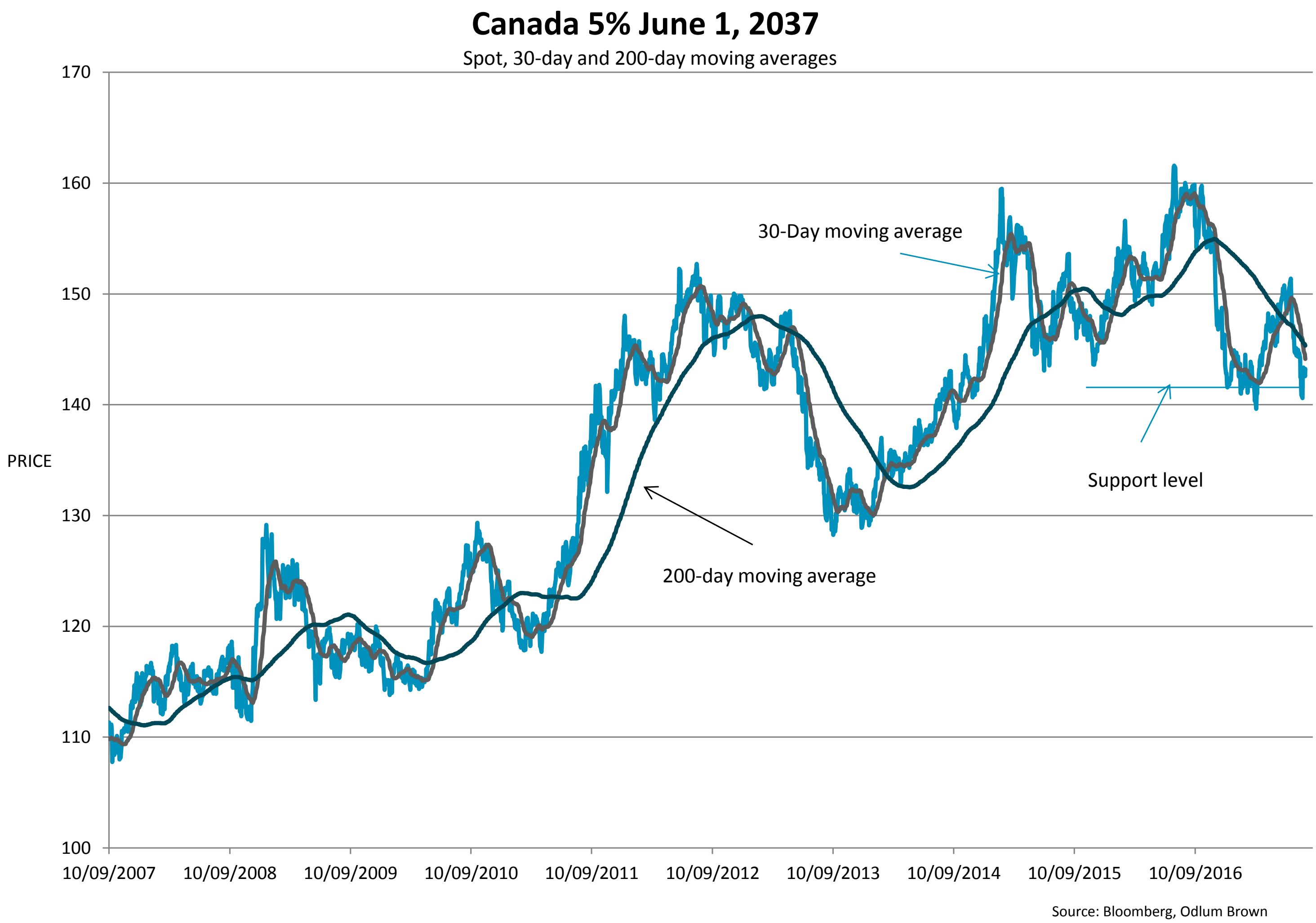
This was all about Canada as the economy fired on all cylinders; GDP growth was strong, presaging a possible growth rate of 3% for the year. Also, our employment picture brightened further, and retail sales were robust .This prompted the Bank of Canada to raise its key lending rate by 25 basis points for the first time in six years. The Bank accompanied this increase with upbeat economic comments, leaving little doubt that it was prepared to hike rates again soon.

The Canadian dollar responded with a sharp rally, breaching 80 cents U.S. at its best. Foreign investment continues to pour into Canada, the commodity cycle appears to be turning, and our trade experience has improved.

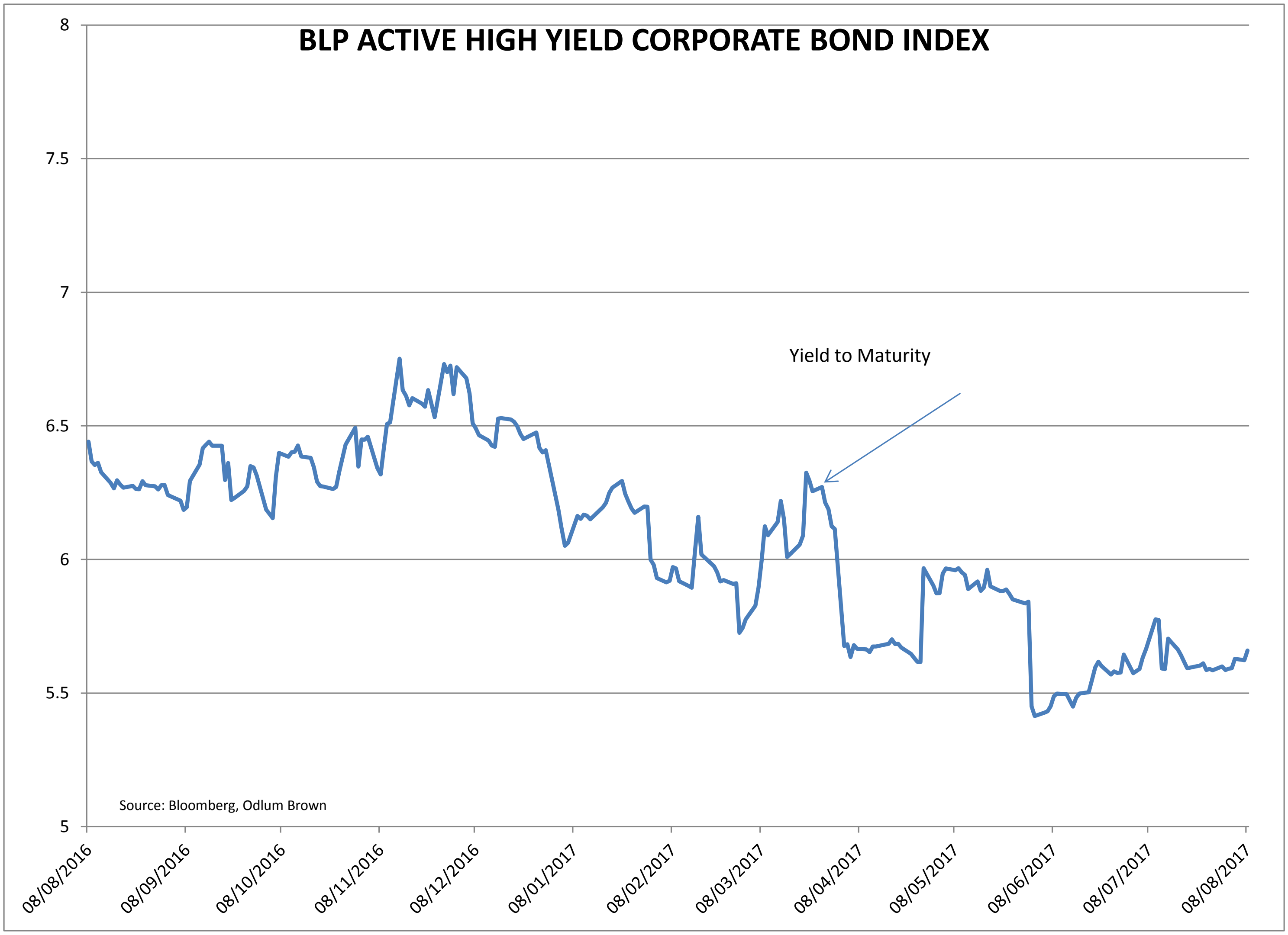
Meanwhile, the U.S. remains mired in its "muddle-through" recovery with growth seemingly stuck at 2.25%. Most economic statistics were middle of the road although the U.S. did report two solid employment reports. However, they were not accompanied by any signs of a pickup in inflation.

As for Europe, the ECB head, Mario Draghi, took great pains to say that more accommodation was still needed and there would be no tapering in the immediate future. This was despite more signs of growth throughout Europe.

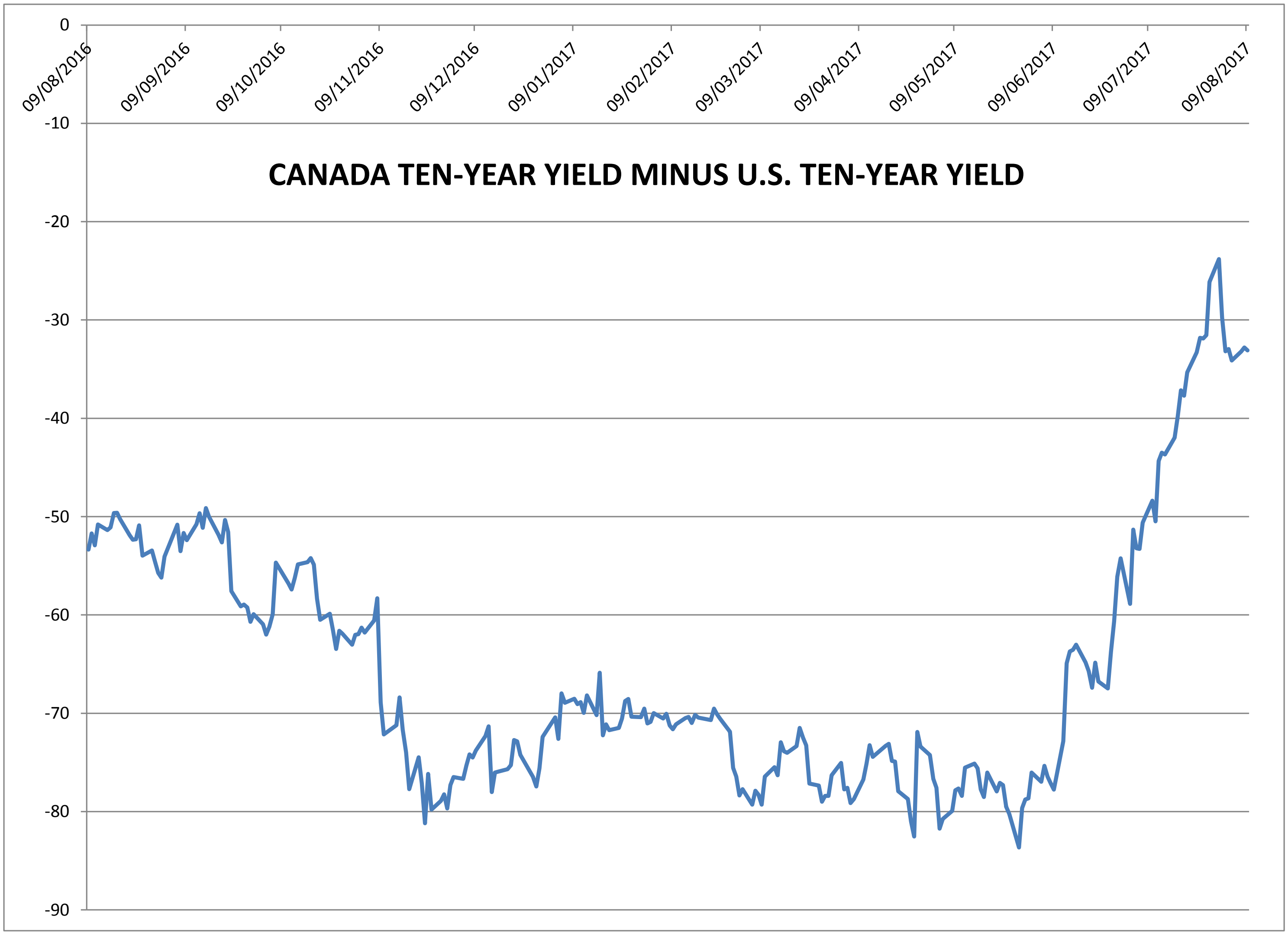
This chart displays the trend of the U.S. ten-year bond yield. It is in a narrow trading range with all the moving averages having converged.



The price of this long-term Canada bond fell sharply, actually falling below an important support line but has since bounced back above it.



High-yield bond yields have continued to move modestly higher from their lows of the year.



This chart displays the continued dramatic narrowing of the yield between the ten-year U.S. and Canadian bonds. This marks the second consecutive month where Canadian yields have risen sharply.

Outlook

We continue to believe that the line of least resistance is towards higher bond yields. While U.S. growth is mired at 2.25%, there is no recession in sight as key economic variables such as the employment sector, retail sales, and consumer confidence, to name a few, remain positive. Furthermore, the yield curve, despite some flattening in recent months, remains a positive 95 basis points, close to its long-term average.

The Federal Reserve has moved to a less-hawkish stance as it ponders the lack of any acceleration in inflation. CPI is at a weak 1.3%. Thus, the Fed will likely hold off on further rate hikes until December. In the meantime though, it plans to begin the delicate unwinding of its bloated balance sheet in September.

As for Canada, our economy is leading the G7 in growth estimates for this year and the Bank of Canada has noted that the output gap may be closed by year-end. This augurs for more normalization by the Bank although some would argue that the recent rise of the Loonie may have done the tightening for the Bank.

A seldom-discussed by-product of the economic surge in Canada is that the Federal deficit could shrink by $5.5 billion. Should this growth bounce continue, it may be time to remove some of the excessive fiscal stimulus.

The rest of the world's growth has picked up and the commodity cycle may have turned.

Against this backdrop, bond yields should rise, with the U.S. ten-year heading for the 2.50-3.00% range.

Strategy

We see little reason to alter the strategy of maintaining a high-quality fixed income portfolio with a relatively short duration. This is a time when protection of principal becomes of paramount importance. Where possible and practical, we favour upgrading the quality of portfolios as there are some danger signals emerging in credit markets. High yield bonds have begun to move higher and are likely to offer average returns for the balance of the year.