MONTHLY FIXED INCOME UPDATE

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Interest Rate Summary	30-Dec-16	31-Dec-15	31-Dec-14	31-Dec-13	31-Dec-12	31-Dec-11
U.S.						
3-Month T-Bill	0.50%	0.16%	0.04%	0.07%	0.04%	0.01%
2-Year Treasury	1.19%	1.31%	0.47%	0.38%	0.25%	0.24%
10-Year Treasury	2.44%	2.27%	2.17%	3.03%	1.76%	1.88%
Canada						
3-Month T-Bill	0.45%	0.51%	0.90%	0.92%	0.92%	0.80%
2-Year Canada	0.74%	0.48%	0.99%	1.14%	1.14%	0.96%
10-Year Canada	1.72%	1.39%	1.86%	2.76%	1.80%	1.94%

Performance

	Dec 2016	Year-to-Date	2015	2014	2013	2012	2011
DEX Universe Bond Index	-0.50%	1.66%	3.52%	8.79%	-1.19%	2.65%	9.67%
DEX Federal Bond Index	-0.62%	0.00%	3.66%	6.91%	-1.52%	2.11%	8.41%
DEX Provincial Bond Index	-0.64%	1.76%	4.14%	12.18%	-2.70%		
DEX All Corporate Index	-0.16%	3.73%	2.71%	7.58%	0.84%	6.22%	8.24%
DEX “A” Corporate Index	-0.25%	3.60%	2.62%	9.10%	-0.16%	6.85%	10.1%
DEX Real Return Bonds	-2.26%	2.86%	2.79%	13.18%	-13.1%		
DEX High Yield Bonds	1.70%	16.93%					

Comments:

Performance in all sectors except high yield was negative again in December. This marked the fifth straight month of negative total returns for investment-grade bonds. Corporate bonds outperformed Government bonds for the month and for all of 2016. Long-term bonds were the poorest performers.

The U.S. ten-year note tacked on a mere six basis points for the month but this masked the results somewhat. Early in December, bond yields kept on rising after another good employment report; in addition the OPEC nations surprised the markets with a significant reduction in oil production.

Following are the reasons cited last month for this rise in bond yields:

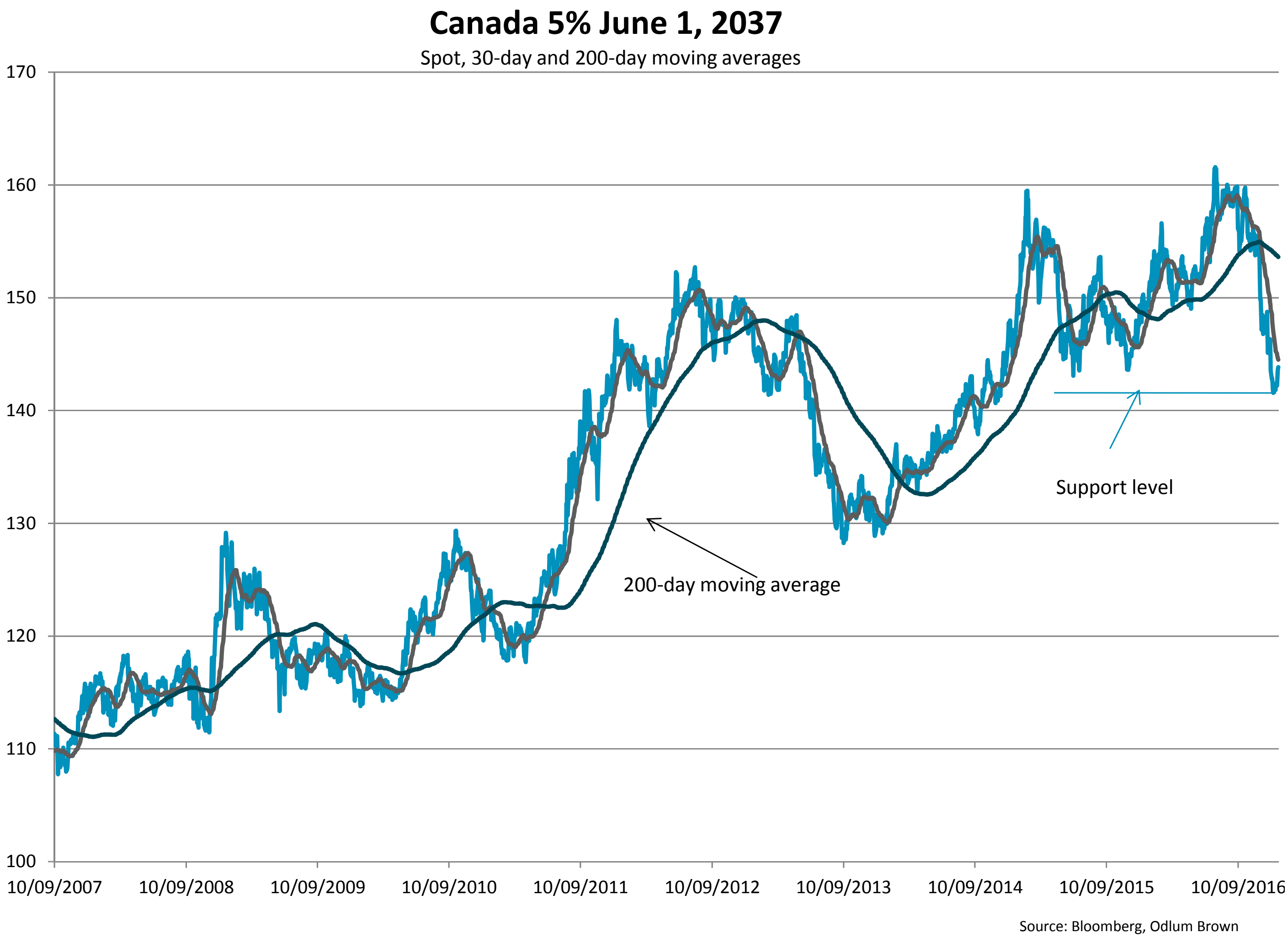
1. Growing fears that central banks were beginning to reduce monetary accommodation.
2. Rising inflation expectations.
3. Foreign central banks and sovereign wealth funds selling over $400 billion of U.S. treasury bonds thus far this year.
4. The Federal Reserve signalling that it was prepared to normalize short-term interest rates beginning in December.
5. U.S. Q3 GDP surprising on the upside.
6. Economic fundamentals continuing to improve, not only in the U.S., but also in Europe and China.

The Fed did raise the Federal Funds Rate by 25 basis points on December 14 and surprised the markets by signalling the possibility of three additional hikes in 2017. The language accompanying the press release was on the dovish side. Coincidentally, the ten-year Treasury hit its monthly high yield of 2.60% on the day after the hike. From December 15, its yield fell gradually to 2.44%.

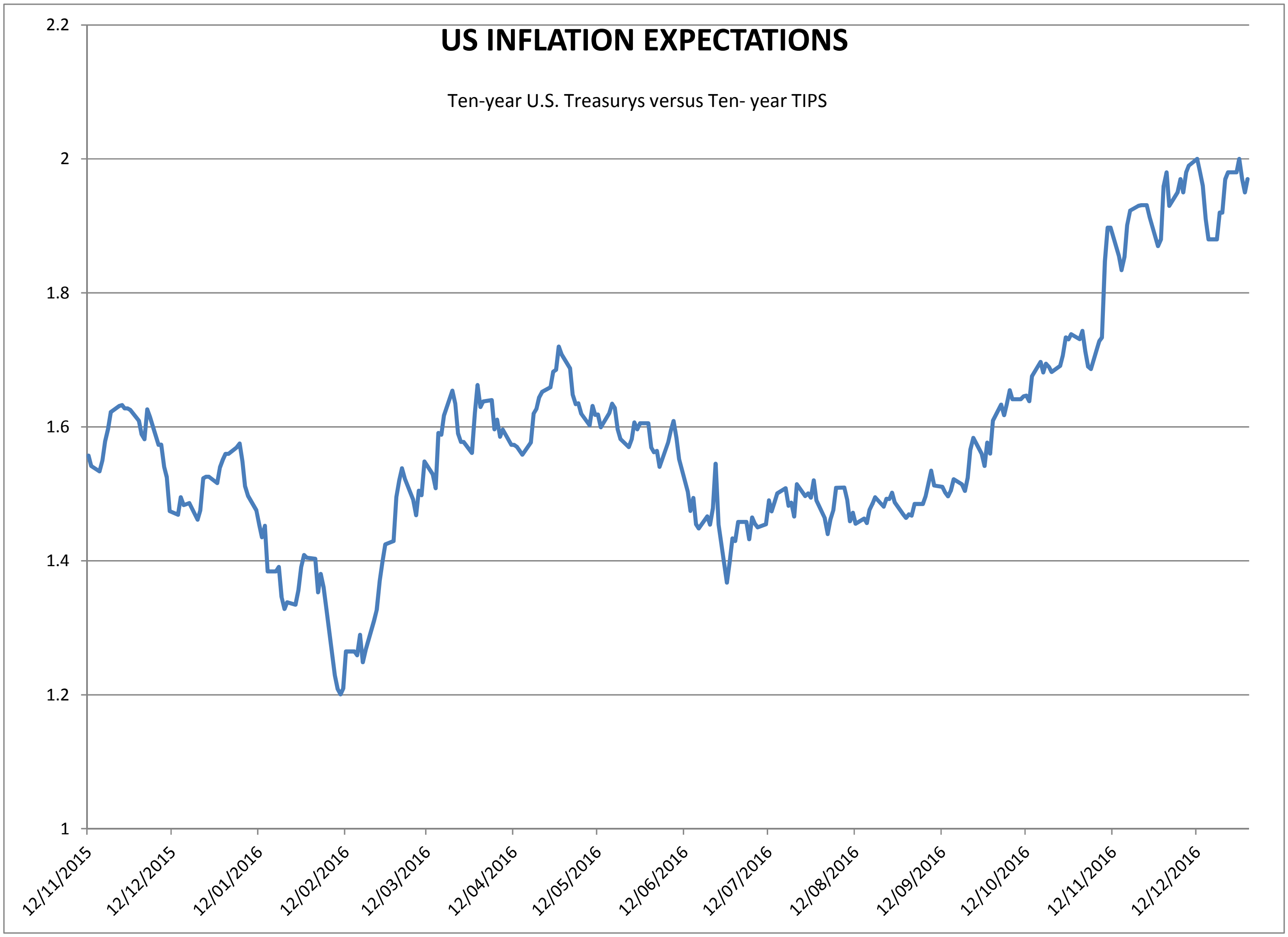
The fundamentals remain relatively solid for the U.S. economy and conditions around the globe continue to improve. It appears that the bond market may have over-reacted in the short term after the election as sober second thoughts cast doubt on how quickly Trump initiatives will bring about any near-term uptick in growth.

Canada reported some sub-par economic news in December, which resulted in a clear dovish stance by the Bank of Canada as it left the overnight rate unchanged. Thus, Canada maintains an easy monetary policy while the Fed begins to tighten. This brought pressure on our currency for much of the month but it was buoyed by firming energy and commodity prices in the latter part of the month.

This chart displays the trend of the U.S. ten-year bond yield. It is too early to forecast that a new long-term trend has begun as there is considerable resistance at 3%.



The price of this long-term Canada bond plummeted but has bounced off a key support level.



This chart demonstrates that inflation expectations are rising. The break-even inflation rate has been rising steadily over the past several months and has spiked since the election.

Outlook

Have we seen the end of the secular decline in bond yields? No one knows for sure and it is too early to tell. It would take a decisive move above 3% on the U.S. ten-year to convince market pundits that a new trend is in place. One has only to cite the global economic improvement, the move towards tightening on the part of the Fed, and the stirring of inflation and wage pressures to underscore that this could happen.

Nevertheless, many of the factors holding bond yields down are still in place:

1. Weak economic growth. The U.S. will be hard-pressed to reach a 3% growth rate in 2017.
2. The aging populations in developed countries argue for more saving and thus, lower interest rates.
3. Any successful attempts at deregulation will reduce business costs.
4. The strong U.S. dollar will suppress imported inflation.
5. Also, with the lags inherent in infrastructure planning and spending, combined with what is likely to be a lengthy debate on the Federal deficit, it is more likely that the initiatives proposed by the President-elect will affect economic growth more in 2018 than in the current year.
6. Inflation, while stirring, is still under 2% and is not showing any signs of a breakout.

Macroeconomics is not the sole determinant of interest rates and bond yields. Supply and demand are also important factors. Consider that the U.S. deficit stands at $576 billion, or 3% of GDP. At the margin, Trump's policies will add to the deficit. Further, the new Secretary of the Treasury is proposing a significant increase in the issuance of long-term bonds. Along with the likelihood of an expanding deficit, this will add pressure to long-term yields.

Deficits are appearing throughout the developed world; Canada and its provinces, long models of fiscal rectitude, are running deficits totalling some $50 billion for the current fiscal year and for the 2017-2018 fiscal year as well.

At the same time, significant holders of U.S. Government bonds, most notably China, Japan and Brazil, have been large net sellers of some $400 billion in 2016. Moreover, as these countries prop up their currencies with their foreign exchange reserves, they will continue to be net sellers of U.S Treasuries.

Manufacturing is showing a decided pickup in Europe along with some inflation and as China's outlook is more promising, the near term should feature a continued uptrend in market yields.
Thus, we feel there is a possibility that the U.S ten-year may reach 3% sometime this year but it could also retrace part of its recent rise and move back down to 2%. It will likely end the year at a higher yield than from the 2016 year-end level of 2.44% and thus total returns will be barely positive.

Investment-grade corporate bonds should fare somewhat better as the borrowing calendar should be lighter than last year. High-yield bonds will likely produce positive returns as the default rate is falling and as they offer a healthy yield cushion over Government bonds.

As for Canada, the consensus outlook is for 1.8% growth in real GDP this year. After the weak fourth quarter, the Bank of Canada has remained clearly on the sidelines and even hinted at a decrease in its key lending rate. With the possibility of three hikes in the Fed Funds rate by the Federal Reserve, a larger gap in short-term yields will open up, adding to pressure on our currency. As mid and long-term bond yields will likely trend higher along with U.S. yields, the result will be a steeper yield curve.

Strategy

We see little reason to alter our advice to remain fully invested in short duration corporate bonds diversified by credit and maturity. Those investors who have maintained their laddered approach have enjoyed positive returns at all maturities. As always, in the investment-grade portion of a fixed-income portfolio, we are ever mindful of credit risk and remain advocates of those credits non-cyclical in nature. Our emphasis remains on safety of principal.

Although we recommend up to 10% of a fixed-income portfolio be invested in high-yield credits, either by way of ETFs or via careful selection of individual bonds, we now counsel caution. High-yield bonds have reached their lows in yield for the year and may have achieved most of their potential return. Should investment-grade bond yields continue to trend higher, there will be pressure on high-yield bonds although we expect that they will produce positive total returns.