Monthly Fixed Income Update

Hank Cunningham **January 8, 2018**

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

Performance

	Dec-2017	2017	2016	2015	2014	2013	2012
DEX Universe Bond Index	-0.41%	2.52%	3.52%	3.52%	8.79%	-1.19%	2.65%
DEX Federal Bond Index	-0.63%	0.13%	3.66%	3.66%	6.91%	-1.52%	2.11%
DEX Provincial Bond Index	-0.21%	4.33%	4.14%	4.14%	12.18%	-2.70%	
DEX All Corporate Index	-0.37%	3.38%	2.71%	2.71%	7.58%	0.84%	6.22%
DEX “A” Corporate Index	-0.34%	4. 42%	2.62%	2.62%	9.10%	-0.16%	6.85%
DEX Real Return Bonds	0.12%	0.72%	2.79%	2.79%	13.18%	-13.1%	
DEX High Yield Bonds	0.60%	9.94%					

Comments:

Performance was negative in all sectors of the bond market in December, except for real return and high yield bonds. For the year, provincials, “A” corporates and high yield bonds led the way.

Canadian yields rose by more than their U.S. counterparts in December.

	U.S.	Canada
Three-month Treasury Bills	+12 basis points	+18 basis points
Two-year bond yields	+11 basis points	+26 basis points
Ten-year bond yields	0 basis points	+16 basis points

December’s bond market action featured one more hike in the Federal Funds Rate by the Federal Reserve. This came after further evidence of solid economic growth, emanating from the employment and housing markets, plus buoyant consumer confidence. As well, global growth continued to pick up and the European Central Bank (ECB) signalled a halving in its massive quantitative easing (QE) program.

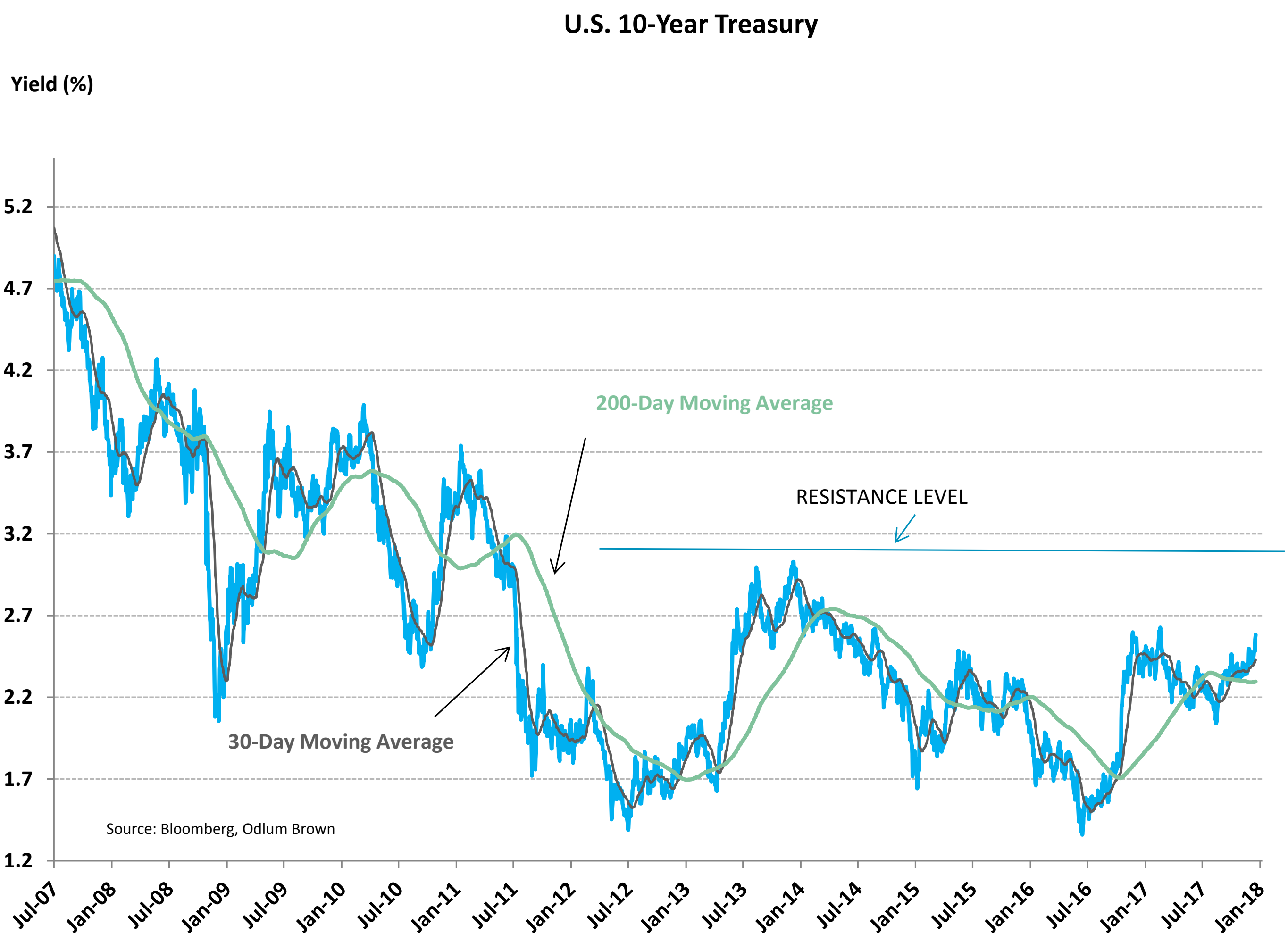
For the month, U.S. three month bills gained twelve basis points, two-year yields gained eleven basis points, while the yield on the ten-year bond was unchanged. This flattened the yield curve further, putting the two-year/ten-year spread at a mere fifty-two basis points.

In addition, the U.S. tax bill passed with the unavoidable conclusion that the federal deficit would expand.

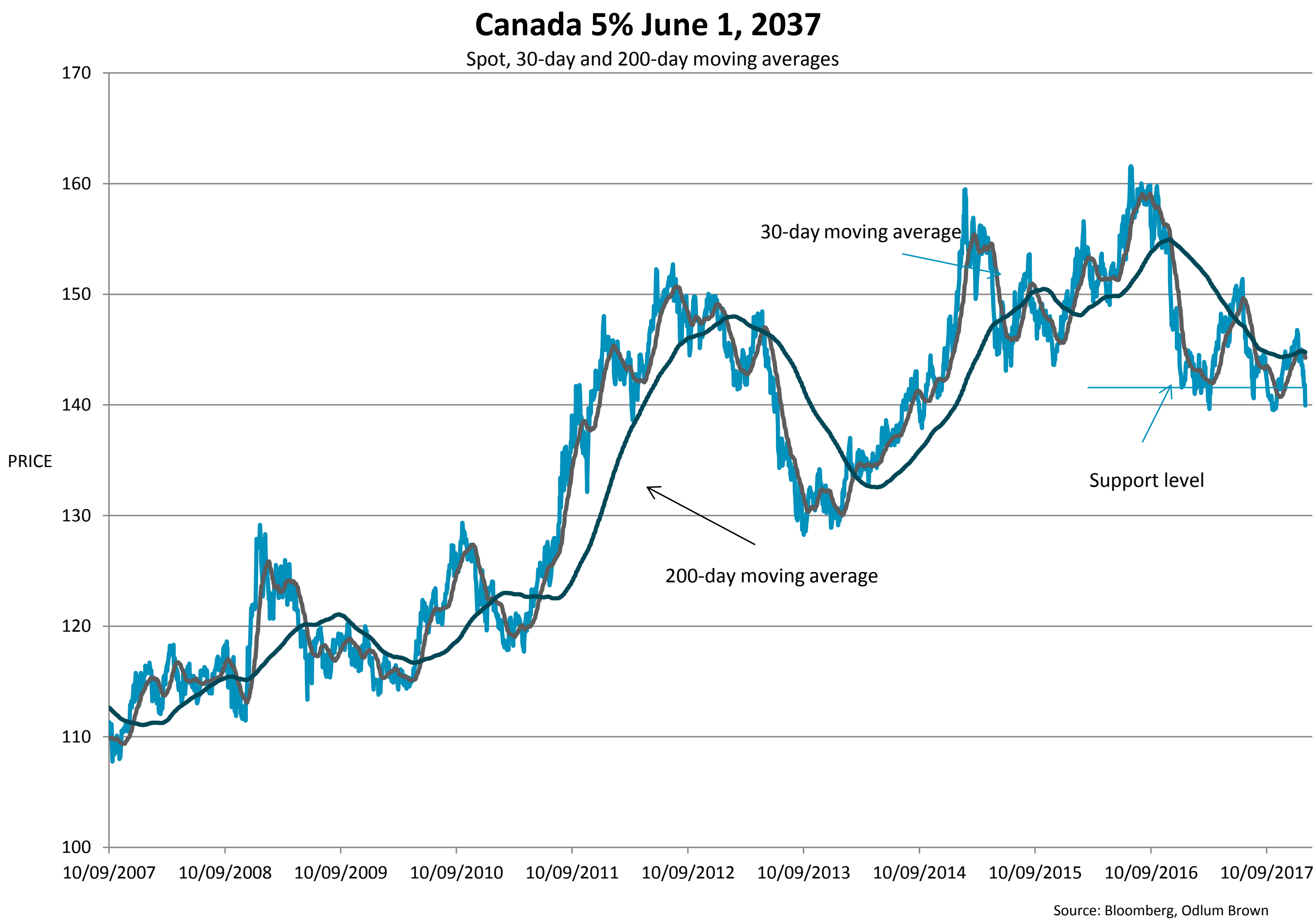
Meanwhile, Canada's prospects improved as exports picked up in an expanding global economy and as the housing market had a blowout month. With commodity prices improving, the Canadian dollar tacked on two and a half cents versus the U.S. dollar.

This was despite a dovish and cautious release from the Bank of Canada. Governor Poloz, while acknowledging the improving global conditions, cautioned about the slack in the labour market. While he did not take a January rate hike off the table, it seemed unlikely until last week's blowout employment report.

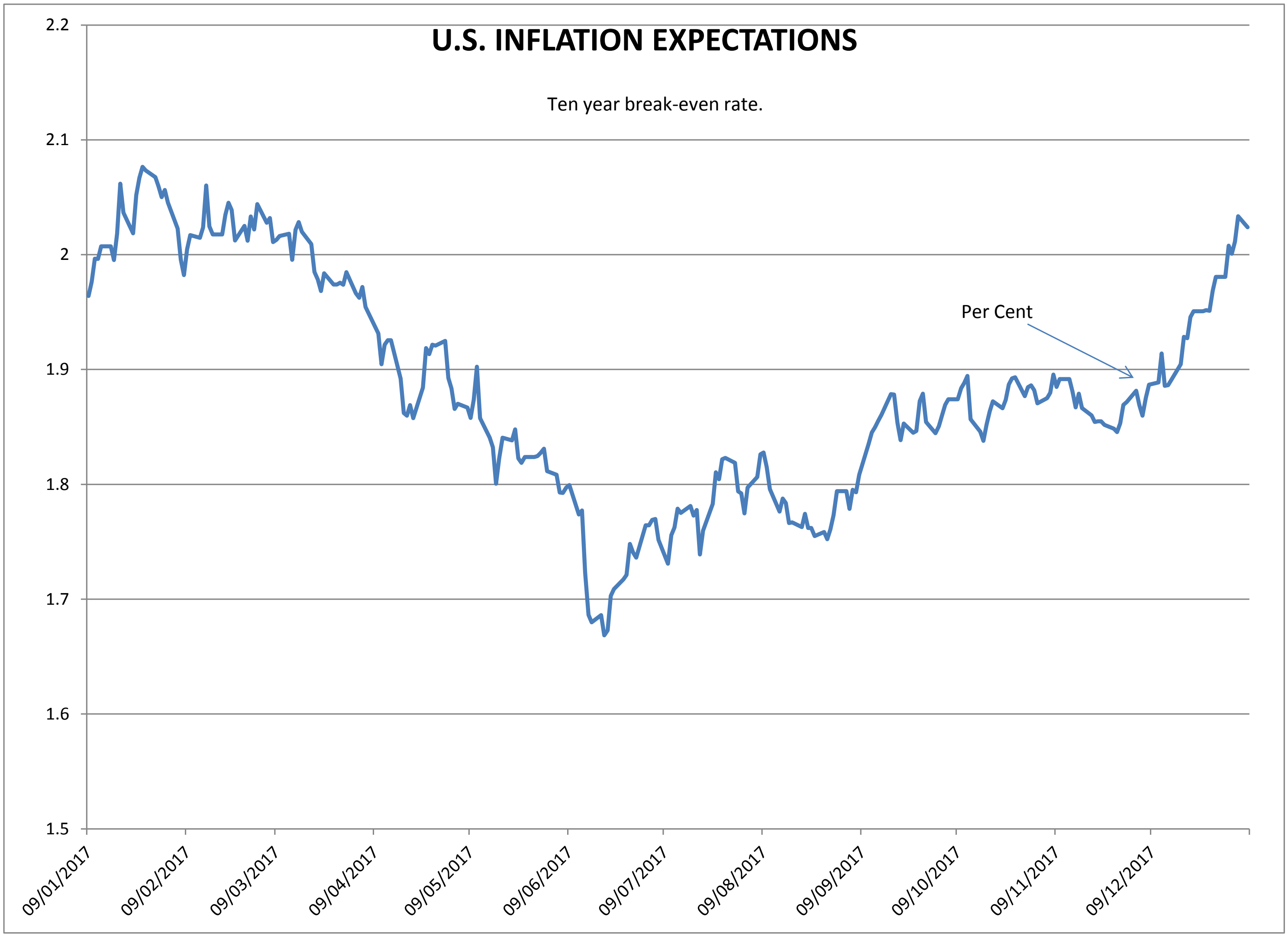
Canadian bond yields rose sharply in December, with two- and ten-year yields rising by twenty-six and sixteen basis points respectively.



The upward bias continues as this note approaches 2.60%. There is serious resistance at 2.63%

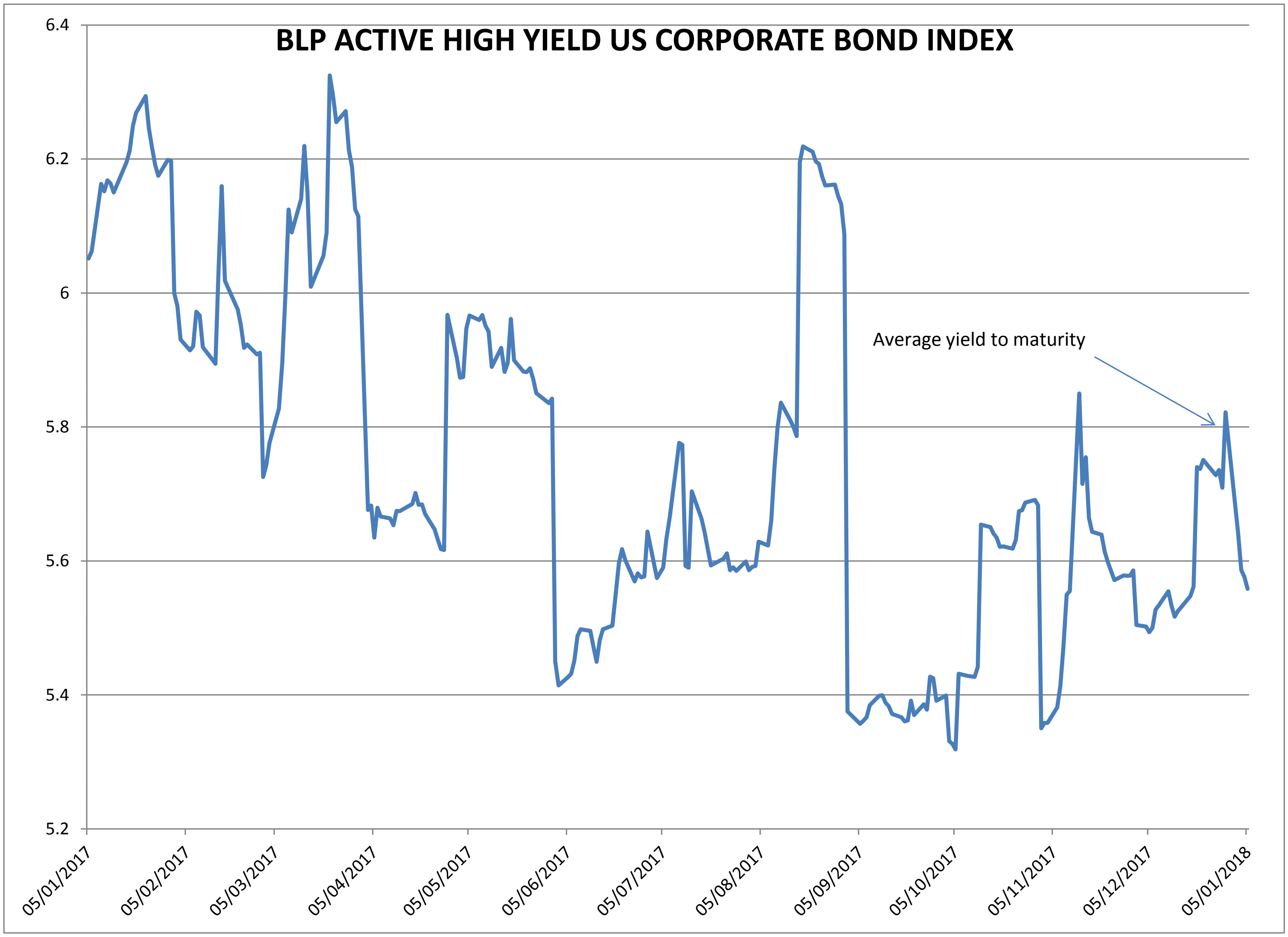


The price of this long-term Canada bond has sold off sharply and has broken through a major support line.



Source: Bloomberg, Odlum Brown

Inflation expectations have been moving steadily higher.



Source: Bloomberg, Odlum Brown

The high yield market has continued to perform well, despite the rise in U.S. Treasury yields.

Outlook

The global economy enters 2018 on an upbeat note and appears set to grow at a 3.5% pace. While many pundits are fretting about the flatter yield curve in the U.S. and the risk of recession, the U.S. economy is advancing at a faster pace with strength in all the important sectors. Inflation, while still low, is stirring. With the employment market so strong, the Federal Reserve, under the guidance of its new Governor, Jerome Powell, is likely to continue to gradually normalize interest rates with at least two more increases in the Federal Funds Rate this year.

By now, longer-term bond yields should be higher but they have been constrained by the extraordinary monetary stimulus elsewhere in the world, particularly in Europe and Japan. In those regions, bond yields have remained artificially low (still negative at shorter maturities) and this has had the effect of making U.S. bond yields relatively attractive.

What seems likely is an upward parallel shift in the yield curve. The next three years will see an enormous increase in the amount of new Treasury bonds issued, in large part as a result of the tax bill. In 2018, the Treasury will issue $1.3 trillion in bonds, double that of 2017 and the most since 2010. There will also be large increases in issuance in 2019 and 2020. While much of the runoff from the Federal Reserve's balance sheet is at the short end of the maturity spectrum, Treasury Secretary Mnuchin is set to offer a greater percentage of longer-dated issues to accommodate the increased supply. Further, if the infrastructure planning gets off the ground, the Treasury will fund the spending with long-term bonds.

Thus, our outlook is for higher U.S. bond yields, with the bellwether 10-year note reaching 3%. Should the ECB and the Bank of Japan pare their QE programs significantly, bond yields would move even higher. Indeed, the Bank of Japan has moved to curtail its QE bond purchase program. Adding more fuel to the supply fire, China has indicated that it may sharply reduce or eliminate its purchase of U.S. Treasury bonds.

As for Canada, our economy continues to confound analysts; the latest employment report was nothing short of spectacular. The market feels that this will force the Bank of Canada to raise the bank rate early in the year and perhaps once or twice more. The Canadian economy, and thus our currency, continues to attract sizeable foreign direct investment. Canadian bond yields have responded, rising faster than their U.S. counterparts over the past two months.

Strategy

Against this backdrop, it is difficult to foresee anything but modest 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. 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.