MONTHLY FIXED INCOME UPDATE

Hank Cunningham **July 9, 2018**

Interest Rate Summary	Jun-29-18	29-Dec-17	30-Dec-16	31-Dec-15	31-Dec-14	31-Dec-13	31-Dec-12
U.S.							
3-Month T-Bill	1.92%	1.38%	0.50%	0.16%	0.04%	0.07%	0.04%
2-Year Treasury	2.53%	1.89%	1.19%	1.31%	0.47%	0.38%	0.25%
10-Year Treasury	2.86%	2.41%	2.44%	2.27%	2.17%	3.03%	1.76%
Canada							
3-Month T-Bill	1.26%	1.05%	0.45%	0.51%	0.90%	0.92%	0.92%
2-Year Canada	1.91%	1.69%	0.74%	0.48%	0.99%	1.14%	1.14%
10-Year Canada	2.17%	2.04%	1.72%	1.39%	1.86%	2.76%	1.80%

Performance

	Jun-2018	2017	2016	2015	2014	2013	2012
DEX Universe Bond Index	0.57%	2.52%	3.52%	3.52%	8.79%	-1.19%	2.65%
DEX Federal Bond Index	0.46%	0.13%	3.66%	3.66%	6.91%	-1.52%	2.11%
DEX Provincial Bond Index	0.82%	4.33%	4.14%	4.14%	12.18%	-2.70%	
DEX All Corporate Index	0.41%	3.38%	2.71%	2.71%	7.58%	0.84%	6.22%
DEX "A" Corporate Index	0.42%	4. 42%	2.62%	2.62%	9.10%	-0.16%	6.85%
DEX Real Return Bonds	1.09%	0.72%	2.79%	2.79%	13.18%	-13.1%	
DEX High Yield Bonds	0.75%	5.20%	13.79%	-5.58%	2.64%	6.87%	

Provincial bonds outperformed investment-grade corporate bonds by a wide margin again. The high yield market also returned positive results.

The U.S. yield curve flattened by ten basis points as the two-year yield rose while the ten-year yield was unchanged. The Canadian yield curve flattened by six basis points.

Comments

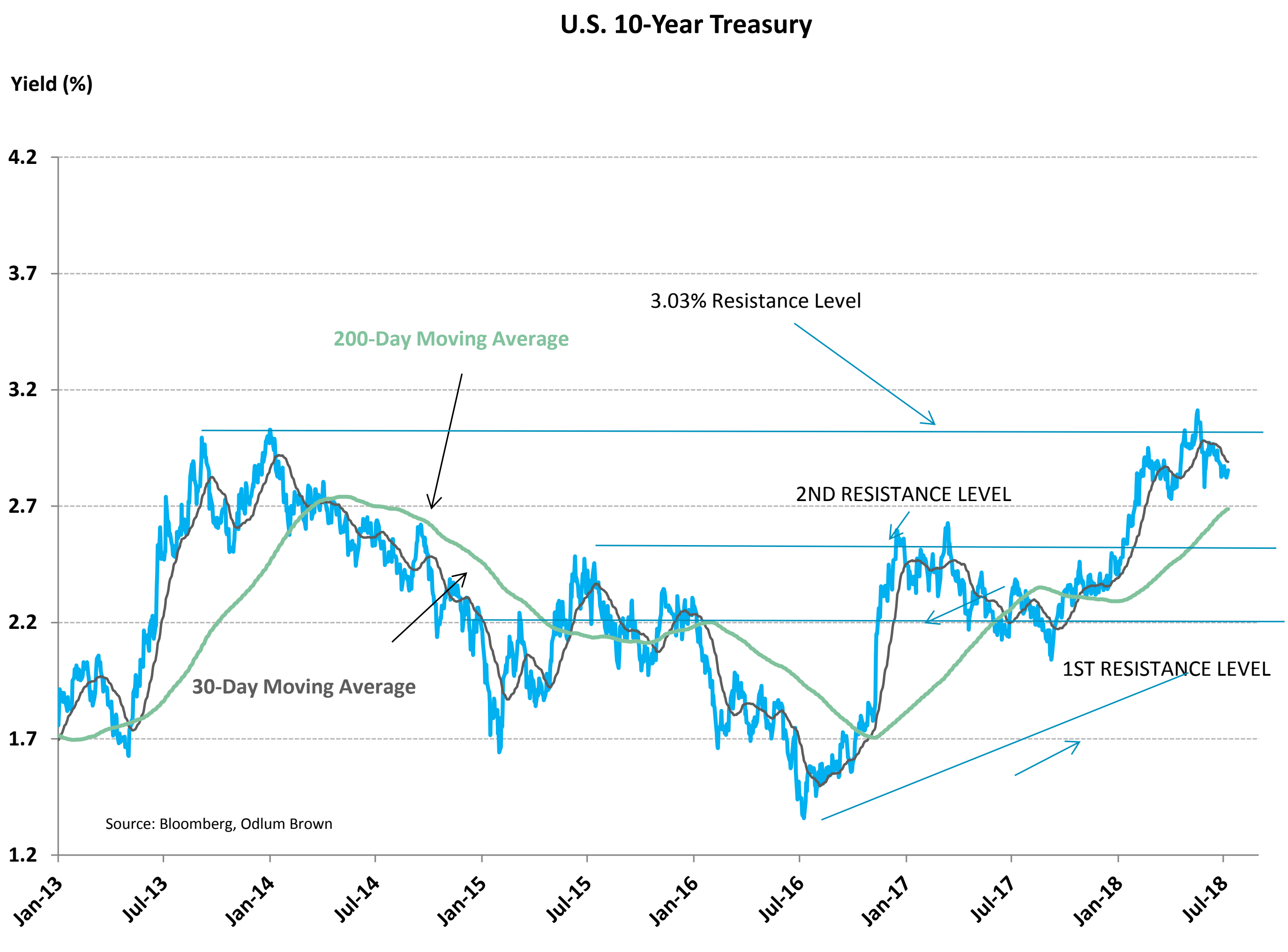
June saw a pickup in inflation in the U.S. as the headline rate hit a six-year high of 2.8% with other inflation measures also increasing. The month began and ended with strong employment reports in the U.S.; a host of solid economic data was released in between, such as housing, industrial production, consumer confidence and retail sales.

The Federal Reserve Board raised the Fed Funds Rate a further 25 basis points and issued an upbeat forecast for the economy, paving the way for two more hikes this year.

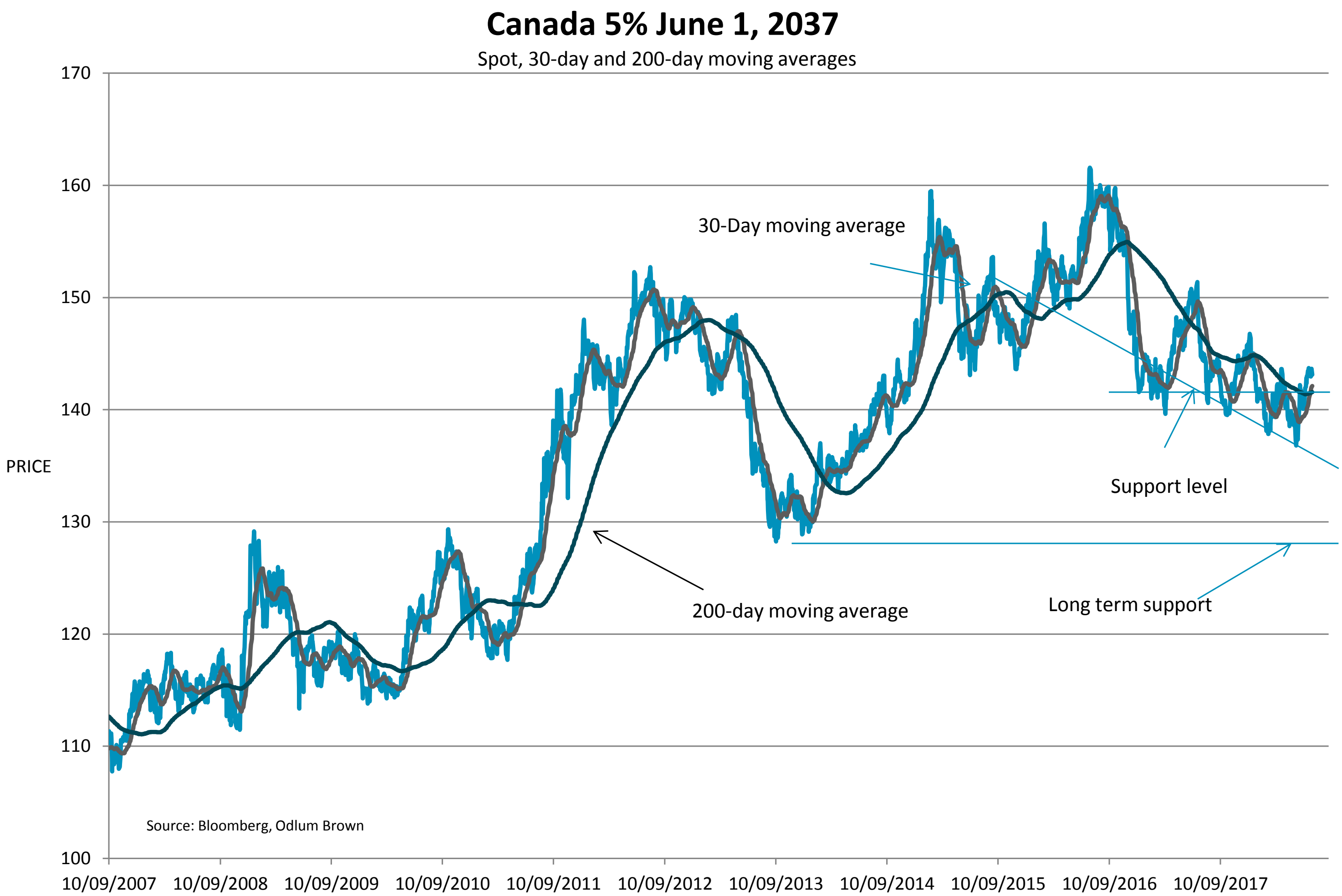
On the surface, one would have expected bond yields to rise but the closely watched ten-year note was unchanged at 2.86%. A couple of items contributed to this: (1) non-energy inflation fell. Copper for example, is down 14% for the year-to-date; and (2) wage growth remained sluggish.

Canada's experience was different. The month began with wage growth hitting 3.9%, followed by a series of weak data, including employment, housing and retail sales. Bond yields fell. The loonie slumped as the market anticipated the Bank of Canada would hold the line on the Bank Rate. As the month progressed, prospects improved with a surprisingly good GDP print, improving trade results and a good employment report. The odds are that the Bank of Canada will raise rates this week.

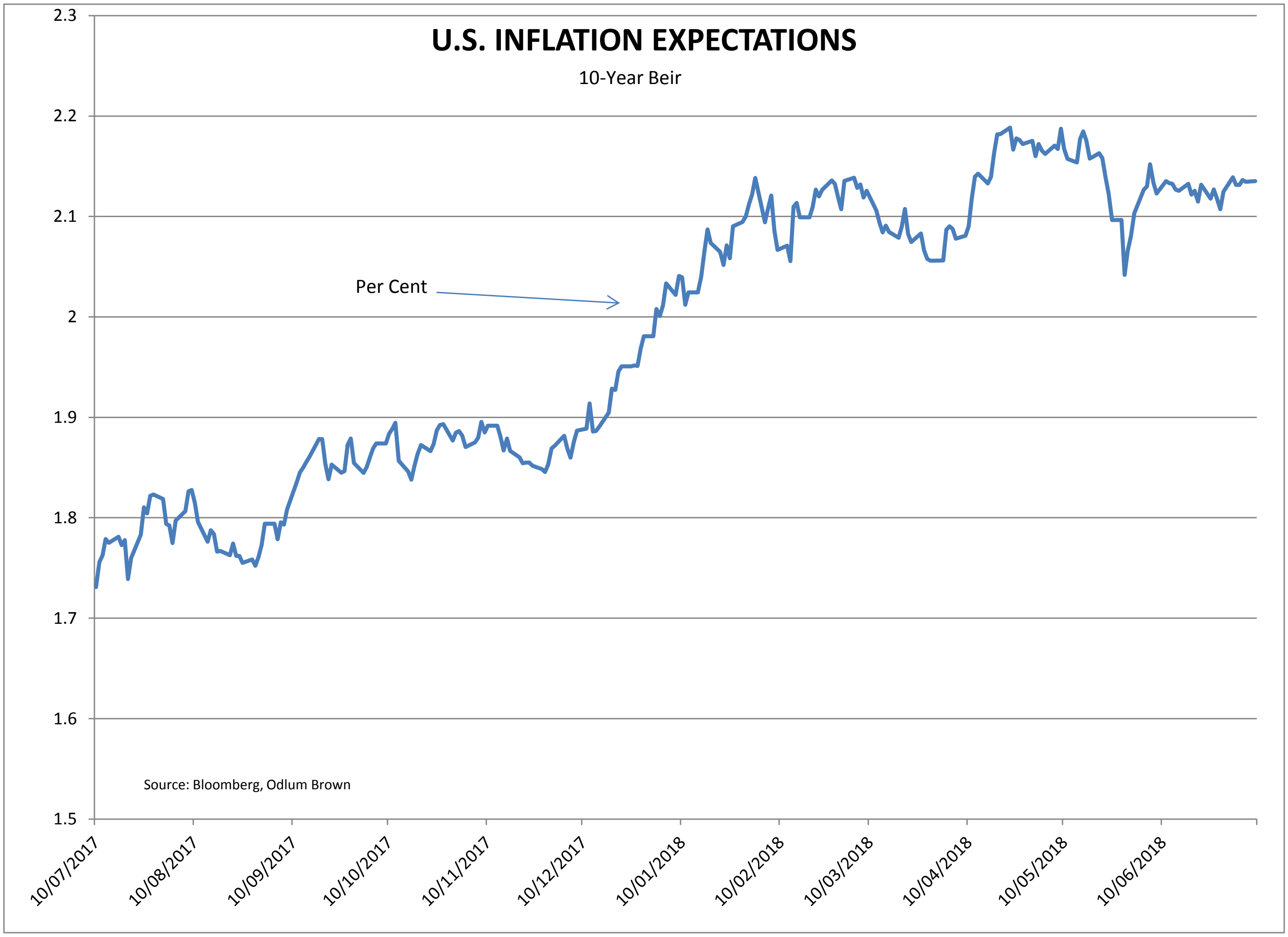
Elsewhere, the European Central Bank spelled out its tapering plans, with quantitative easing to be phased out by year-end.



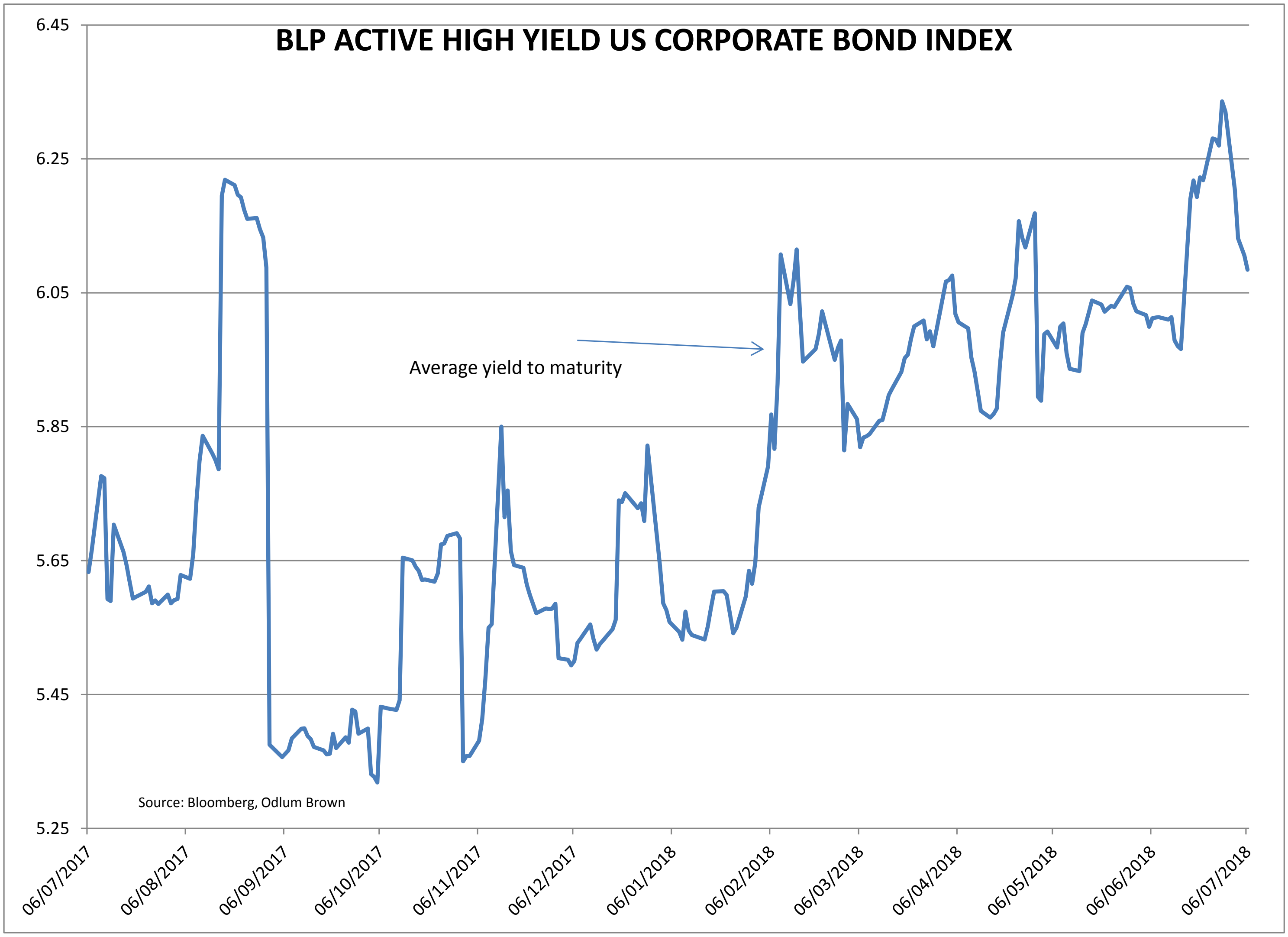
The yield on this bellwether bond is fluctuating between 2.80% and 3%.



The price of this long-term Canada bond rallied further in the past month, moving above all the moving averages with positive momentum.



After recent increases, inflation expectations have stabilized.



The high yield market has been volatile in the past three months but has settled down lately.

Outlook

Given the strong fundamentals for the U.S. economy and the accompanying rise in inflation, ten-year yields should move above 3% soon, with a year-end target of 3.25% a distinct possibility.

The Federal Reserve and the Bank of Canada will continue to withdraw accommodation at a measured pace and thus will move their respective key short-term rates ever closer to "normal."

Overhanging the bond market is the possible detriment to global growth arising from the tussle over tariffs. Neither the Fed nor the Bank of Canada has made any downgrades thus far to their respective forecasts.

Credit markets have displayed some nervousness understandably but, overall, they remain well-behaved.

Strategy

Against this backdrop, it is difficult to foresee anything but modest or negative returns in fixed income portfolios. The preservation of capital should be the main theme for fixed income investors. 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. We also favour floating rate bonds, which stand to benefit from increases in administrative rates by the Fed and the Bank of Canada.

At present, the credit markets are showing only modest signs of strain and yield spreads remain relatively narrow. Should we perceive significant weakness in credit markets, we may advise including selected provincial bonds in clients' portfolios. There is a case to be made for 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.