Monthly Fixed Income Update

Hank Cunningham **June 8, 2017**

Interest Rate Summary	31-May-17	30-Dec-16	31-Dec-15	31-Dec-14	31-Dec-13	31-Dec-12
U.S.						
3-Month T-Bill	0.97%	0.50%	0.16%	0.04%	0.07%	0.04%
2-Year Treasury	1.28%	1.19%	1.31%	0.47%	0.38%	0.25%
10-Year Treasury	2.20%	2.44%	2.27%	2.17%	3.03%	1.76%
Canada						
3-Month T-Bill	0.53%	0.45%	0.51%	0.90%	0.92%	0.92%
2-Year Canada	0.69%	0.74%	0.48%	0.99%	1.14%	1.14%
10-Year Canada	1.42%	1.72%	1.39%	1.86%	2.76%	1.80%

Performance

	May-2017	Year-to-Date	2016	2015	2014	2013	2012
DEX Universe Bond Index	0.86%	3.57%	3.52%	3.52%	8.79%	-1.19%	2.65%
DEX Federal Bond Index	0.67%	2.33%	3.66%	3.66%	6.91%	-1.52%	2.11%
DEX Provincial Bond Index	1.35%	4.62%	4.14%	4.14%	12.18%	-2.70%	
DEX All Corporate Index	0.46%	3.86%	2.71%	2.71%	7.58%	0.84%	6.22%
DEX "A" Corporate Index	0.51%	4.76%	2.62%	2.62%	9.10%	-0.16%	6.85%
DEX Real Return Bonds	1.16%	1.97%	2.79%	2.79%	13.18%	-13.1%	
DEX High Yield Bonds	0.84%	4.38%					

Comments:

Performance was positive in all sectors of the bond market in May. Government bonds outperformed investment-grade corporates and high yield bonds lagged for the third straight month.

The U.S. ten-year note finished the month eight basis points lower at 2.20%, the low for the year and twenty-five basis points lower year-to-date. The yield on the two-year note was unchanged for the second consecutive month, thus underscoring a further flattening of the yield curve.

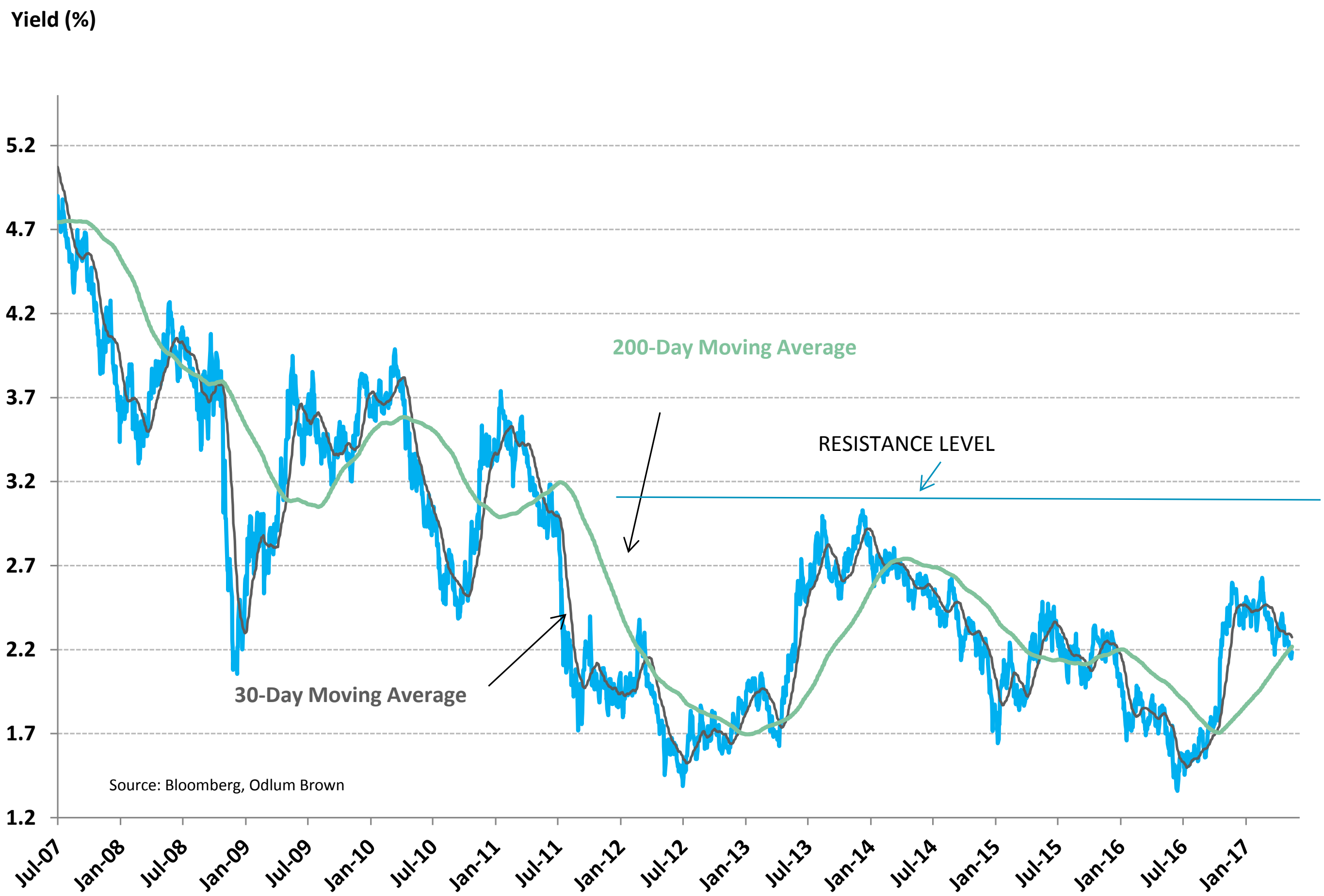
Bond yields fell in response to a cooling in the core inflation rate plus renewed evidence that the reflation trade has faded as a near-term stimulus to growth. April economic data was mildly disappointing; including weakness in retail sales, plus a poorer-than-expected employment report which featured tepid wage growth and fewer nonfarm payroll jobs. Industrial production and manufacturing turned in strong results.

The Federal Reserve is still likely to nudge the Fed Funds Rate higher on June 14 as it regards the recent inflation and weak economic news as transitory.

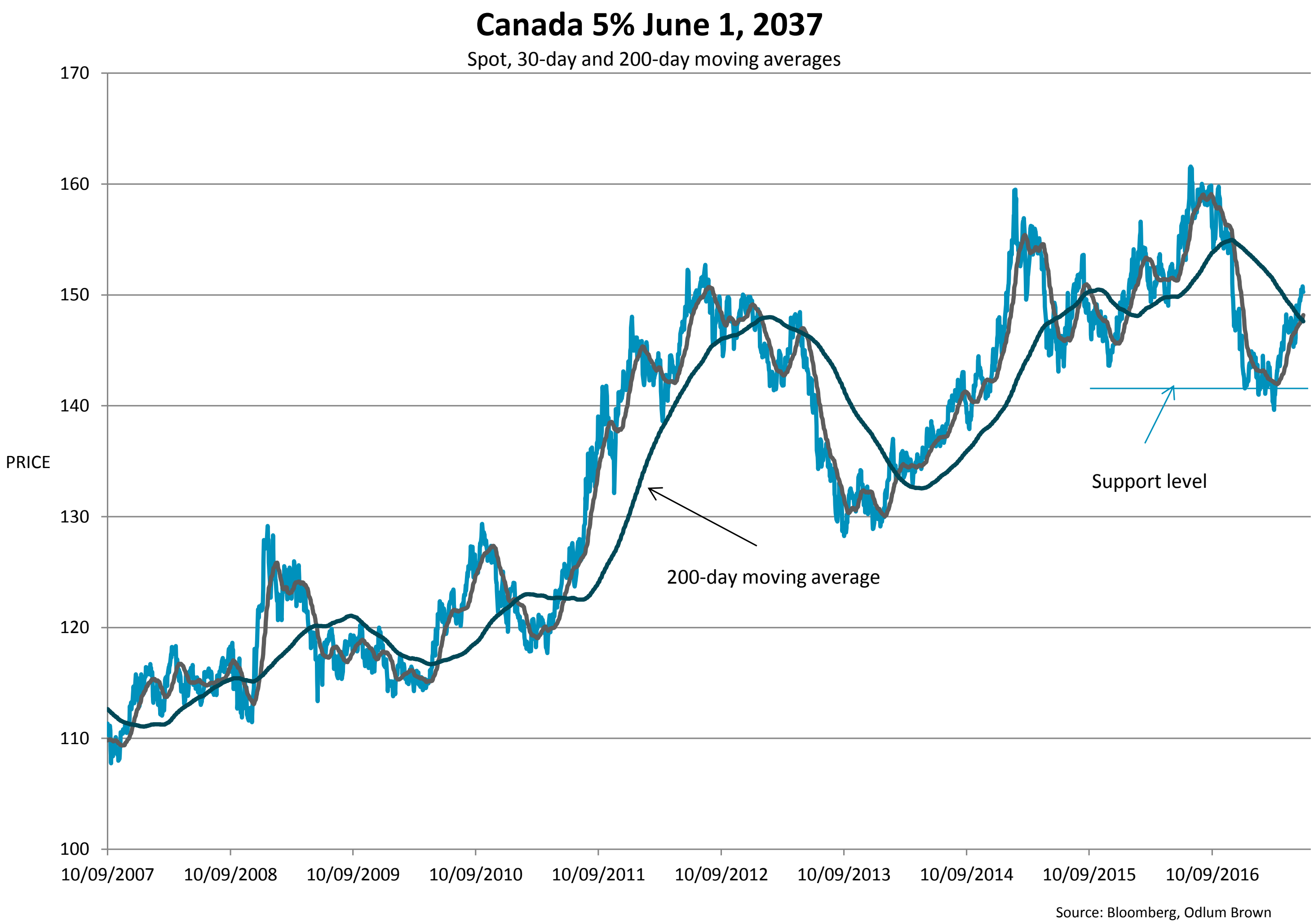
Canada has turned in the best growth in the G7 and should continue this pace. Forecasters peg this year's GDP at 2.5% versus 2.2% for the U.S. The Bank of Canada has become more optimistic regarding Canada's economic performance and market pundits are pencilling in a hike in the Bank Rate during the next twelve months. The Canadian dollar has suffered from a combination of factors such as weak commodity prices, forthcoming NAFTA negotiations, plus international publicity over our recent housing situation. Nevertheless, our currency has rebounded from the lows in light of improving fundamentals, especially the steady narrowing of the trade deficit.

Globally, economic prospects continue to brighten. The OECD is the latest to chime in with upgraded forecasts for global growth, highlighting improved prospects for the Eurozone.

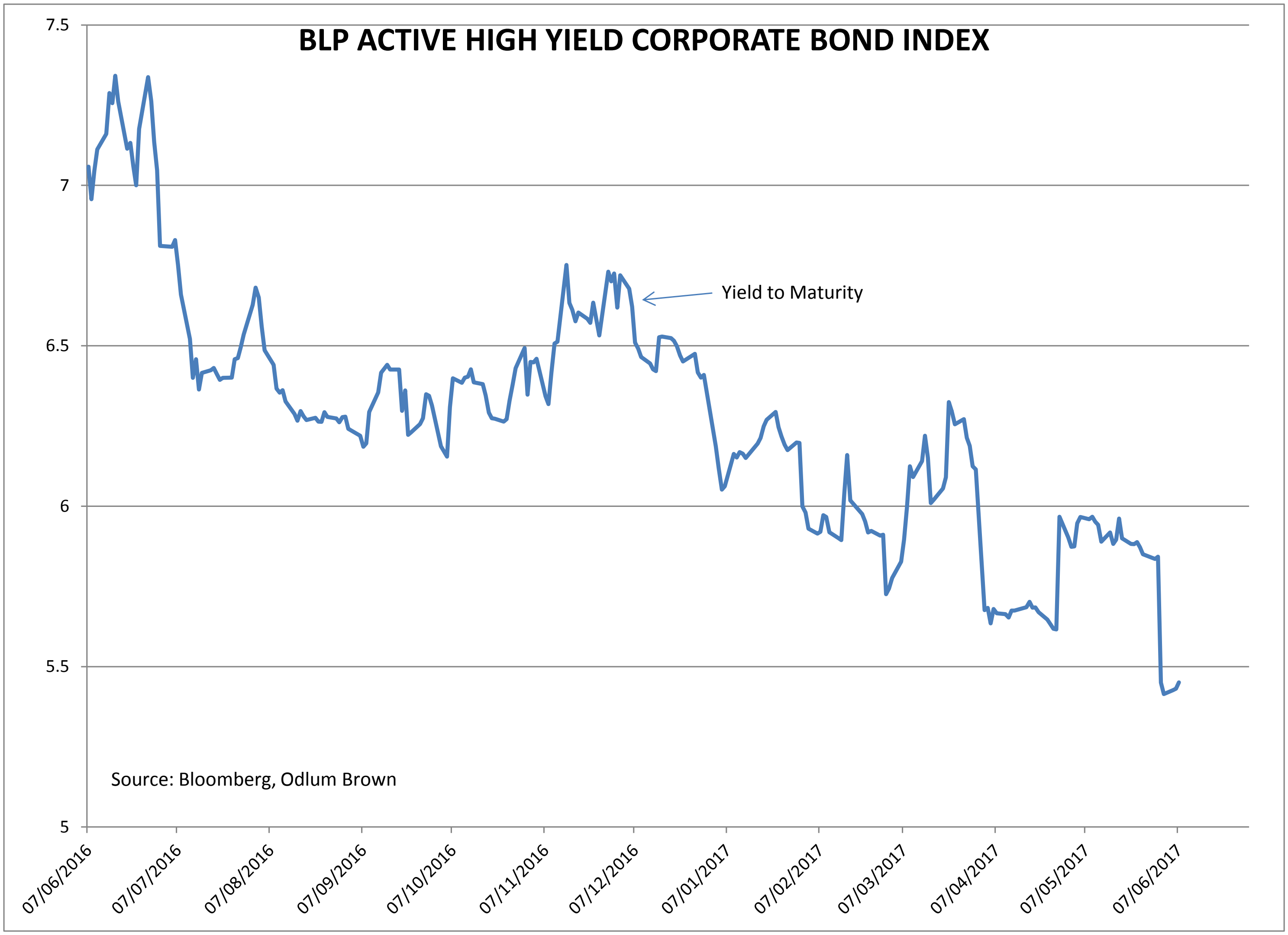
U.S. 10-Year Treasury



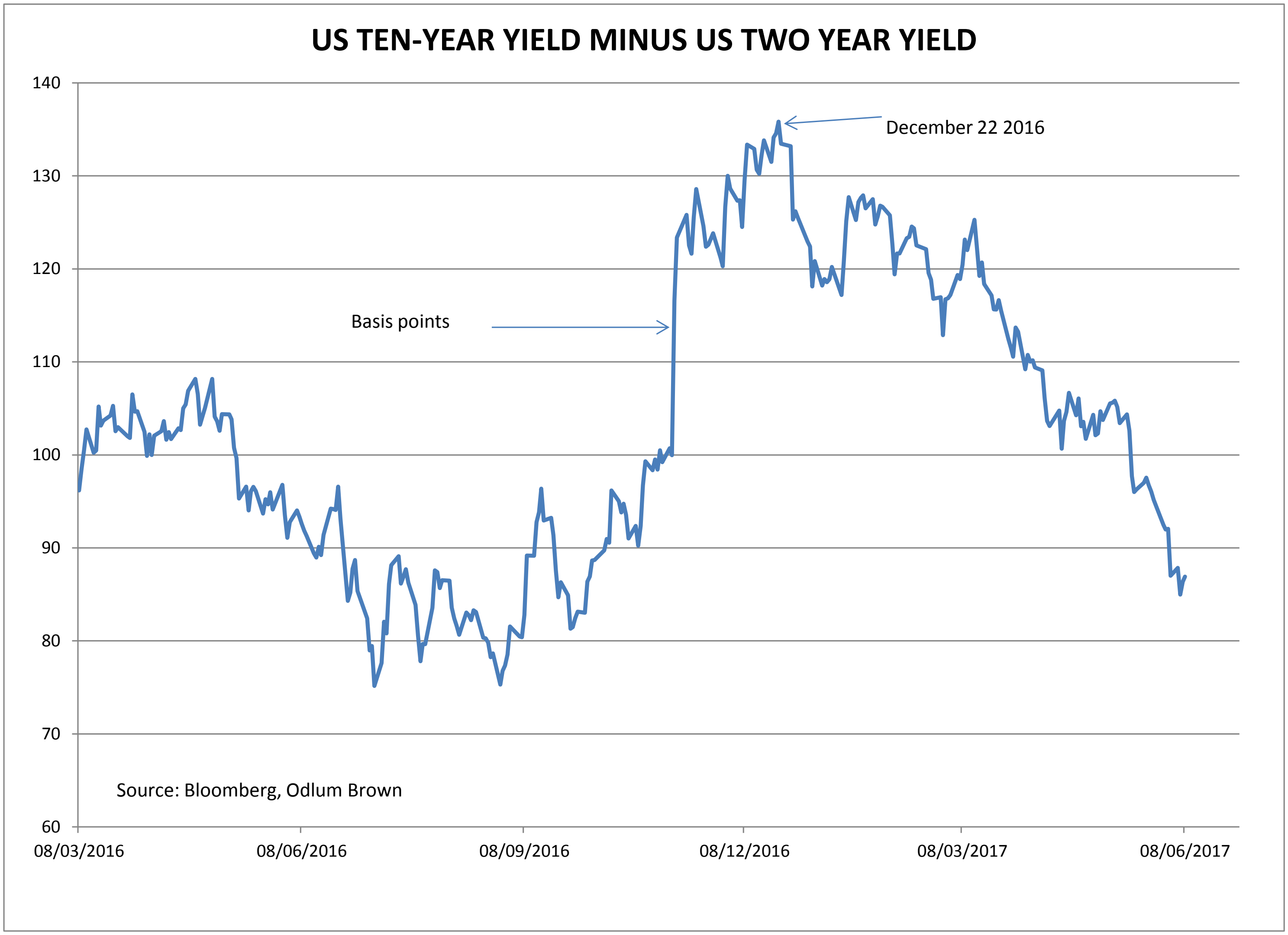
This chart displays the trend of the U.S. ten-year bond yield. It is at the lows in yield for 2017 and is approaching 2%.



The price of this long-term Canada bond has bounced off an important support level and has now moved above its 200-day moving average with rising momentum.



High-yield bond yields have moved to their lows of the year.



This chart displays the dramatic flattening of the yield curve over the past few months.

Outlook

Bond yields are at or close to their lows of the year. With tepid inflation, and still subdued growth, bond yields may fall further and test 2% for the U.S. ten-year note. The Federal Reserve is poised to raise the Fed Funds Rate this month and again in September as it continues on its path to normalization. The Fed is now beginning to address its balance sheet and will likely begin the process of unwinding its bond holdings in an ultra-cautious fashion. The reflation trade has also proven to be a non-starter so far and thus, inflation and growth prospects have been pared back, and the U.S. economy has returned to its slow-growth phase. While the ten-year Treasury may approach 2%, we think that it may yet test 2.6% as the year unfolds with some inflationary pressures emerging.

Strategy

We see little reason to alter the strategy of maintaining a high-quality fixed income portfolio with a relatively short duration. Where possible and practical, we favour upgrading the quality of portfolios as there are some danger signals emerging in credit markets. High yield issuers have responded to strong demand by resorting to "covenant-lite" issues which offer little protection for bond investors. Already, the high yield market has experienced a significant reduction in demand for new issues, which could spill over into the secondary market. Thus, we advise reducing exposure to the high yield bond market.