Monthly Fixed Income Update

Hank Cunningham **June 6, 2018**

Interest Rate Summary	31-May-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	1.90%	1.38%	0.50%	0.16%	0.04%	0.07%	0.04%
2-Year Treasury	2.43%	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	1.28%	1.05%	0.45%	0.51%	0.90%	0.92%	0.92%
2-Year Canada	1.92%	1.69%	0.74%	0.48%	0.99%	1.14%	1.14%
10-Year Canada	2.24%	2.04%	1.72%	1.39%	1.86%	2.76%	1.80%

Performance

	May-2018	2017	2016	2015	2014	2013	2012
DEX Universe Bond Index	0.80%	2.52%	3.52%	3.52%	8.79%	-1.19%	2.65%
DEX Federal Bond Index	0.59%	0.13%	3.66%	3.66%	6.91%	-1.52%	2.11%
DEX Provincial Bond Index	1.22%	4.33%	4.14%	4.14%	12.18%	-2.70%	
DEX All Corporate Index	0.56%	3.38%	2.71%	2.71%	7.58%	0.84%	6.22%
DEX "A" Corporate Index	0.71%	4. 42%	2.62%	2.62%	9.10%	-0.16%	6.85%
DEX Real Return Bonds	1.70%	0.72%	2.79%	2.79%	13.18%	-13.1%	
DEX High Yield Bonds	0.57%	5.20%	13.79%	-5.58%	2.64%	6.87%	

Government bonds outperformed corporate bonds by a wide margin. The high yield market also returned positive results.

		U.S.					Canada	
	Change	Range	Month-End			Change	Range	Month-End
3-Month	0.10%		1.90%		3-Month	0.09%		1.28%
2-Year	-0.06%	2.32%-2.59	2.43%		2-Year	0.03%	1.84-2.06%	1.92%
10-Year	-0.09%	2.78-3.11%	2.86%		10- Year	-0.06%	2.19-2.52%	2.24%

Comments

As the above table displays, the yield curve flattened further in May. It actually steepened early in the month when long-term rates rose quickly but this reversed and the yield spread between the two-year and ten-year U.S. Treasury ended the month at 43 basis points.

May began with a continuation of this year's rise in bond yields. With the U.S. economy throwing off strong retail sales, manufacturing and employment reports, the U.S. ten-year yield rose to 3.11%. Then, it all changed. The catalyst was the release of the FOMC minutes, in which the Fed indicated that it was willing to tolerate inflation running temporarily above its 2% target. Perversely, bond yields fell after this.

The next event was the worsening of the political situation in Italy, with attendant fears of a populist government taking Italy out of the Eurozone. A wild day of trading ensued with the U.S. and German ten-year yields plummeting to 2.78% and 0.20% respectively. Italian bonds had wild sessions, with the two-year yield moving from **minus** 17 basis points to a positive 2.70%! They have settled down now to 0.94%.

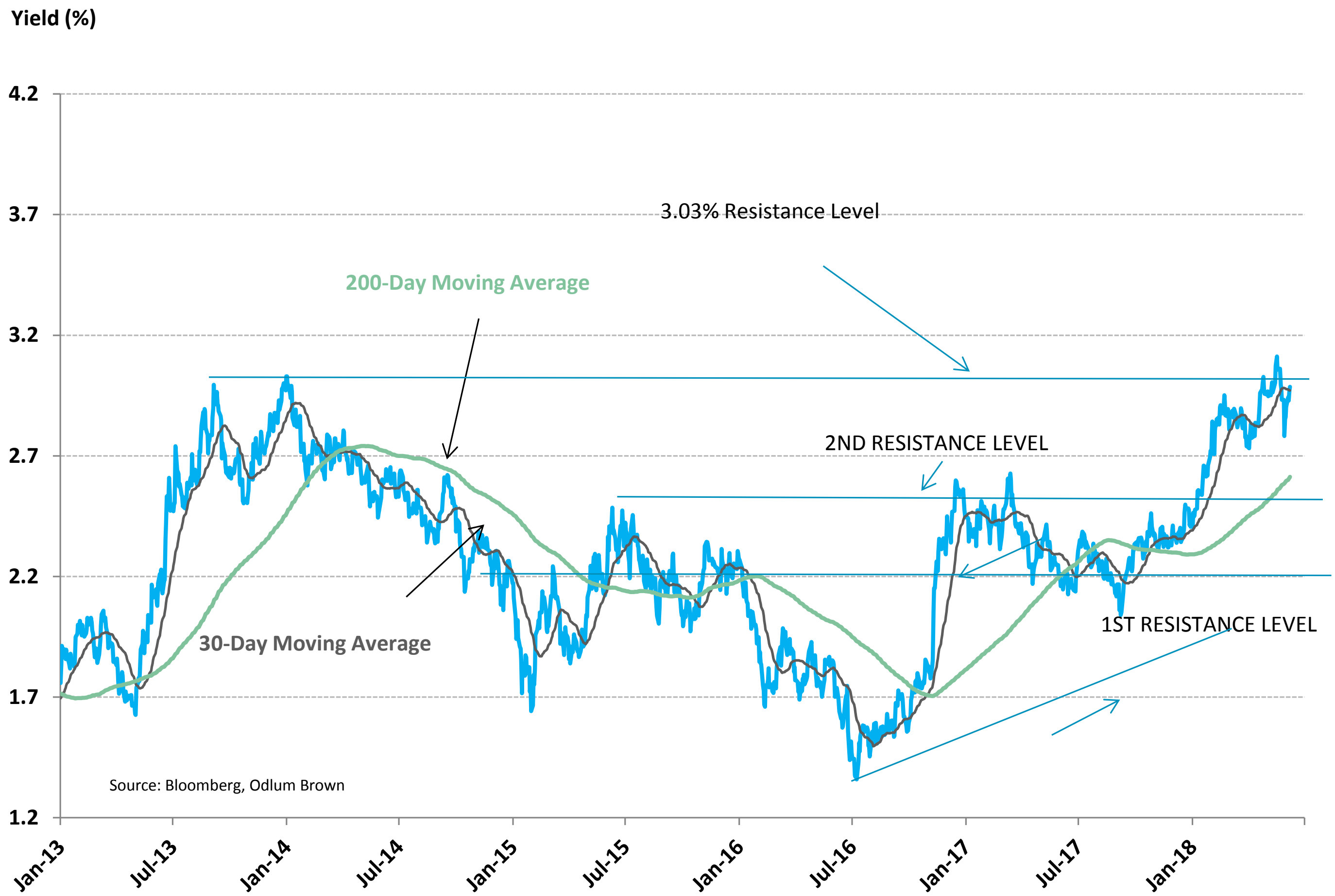
Calm returned and bond yields climbed part way back with the U.S. ten-year reaching 2.86% by month-end, down a mere nine basis points for the month, but down 25 basis points from mid-month highs.

The U.S. economy displayed further strength, culminating with a robust employment report, producing the lowest unemployment rate in 18 years. In addition, wages edged higher, increasing 2.7% year-over-year.

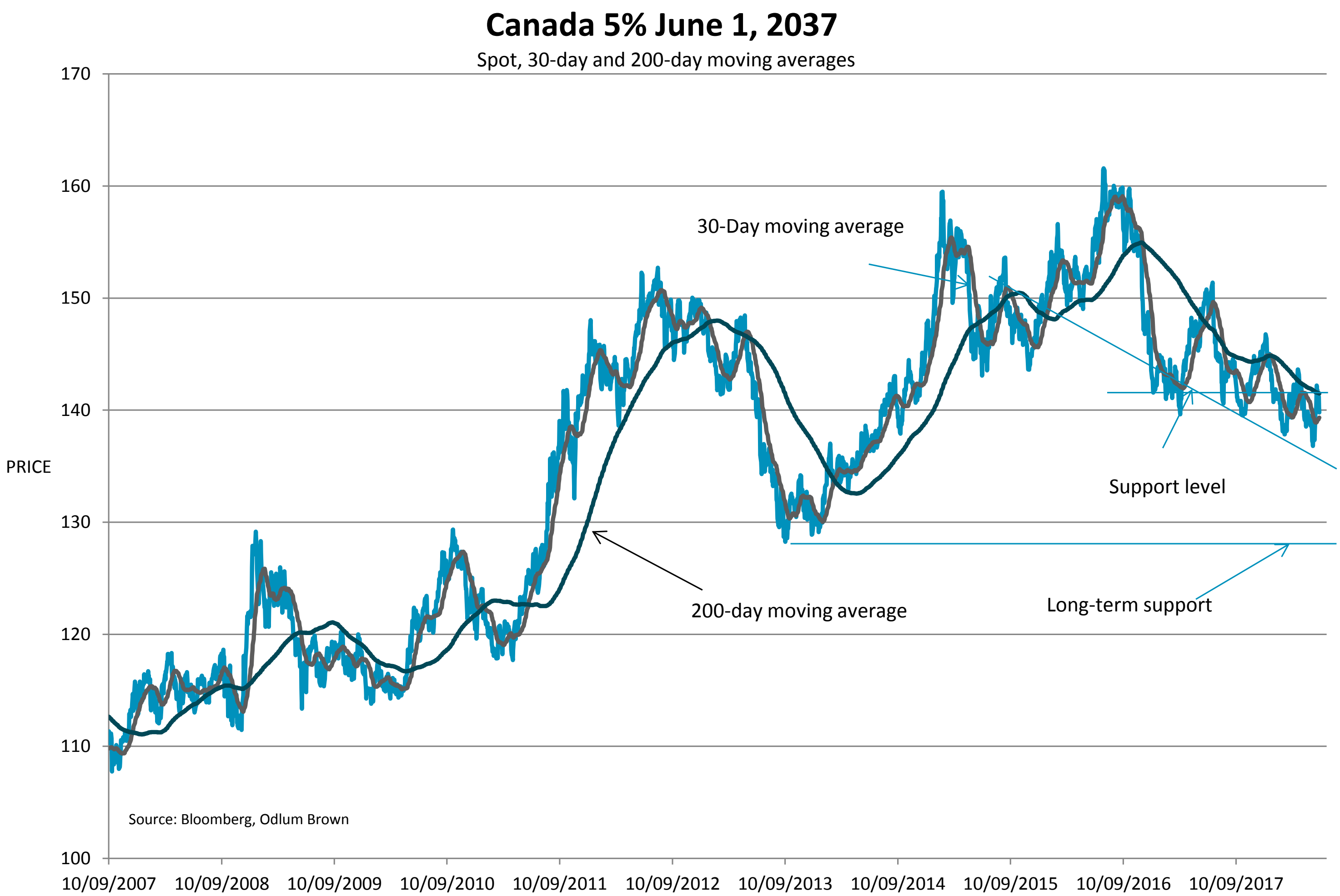
As for Canada, inflation picked up sharply and now exceeds the Bank of Canada’s 2% target. This came despite a struggling housing market and a feeble April employment report. However, solid manufacturing and retail sales combined with surging energy prices have pushed the Bank of Canada to abandon its cautious stance, all but promising an increase in the bank rate at its July 11 meeting.

Besides the turmoil in Italy, the Eurozone produced some weak economic data, underscoring the fragility of its recovery. The ECB head, Mario Draghi, has more than hinted that the quantitative easing program will be wound down by the end of September.

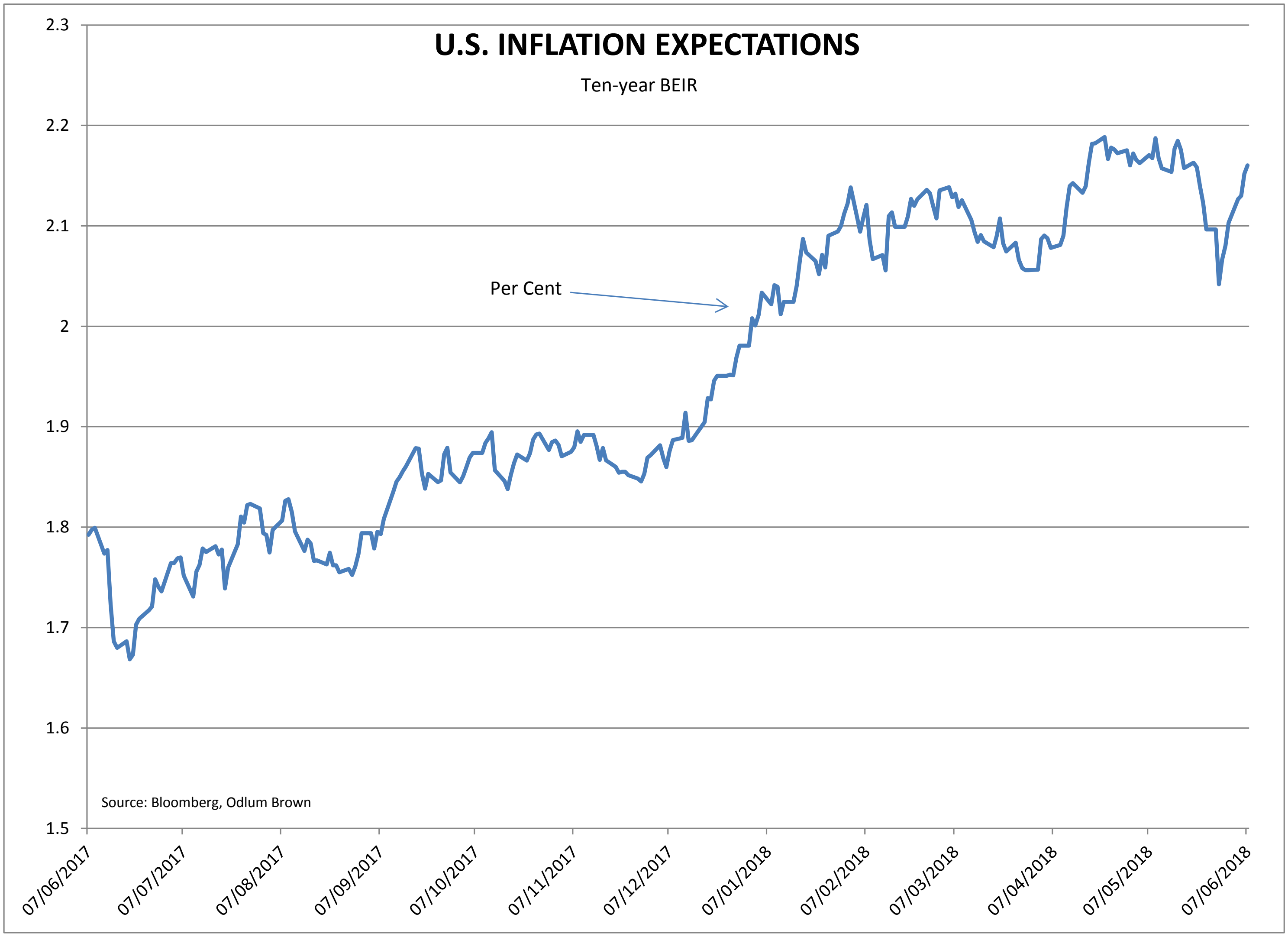
U.S. 10-Year Treasury



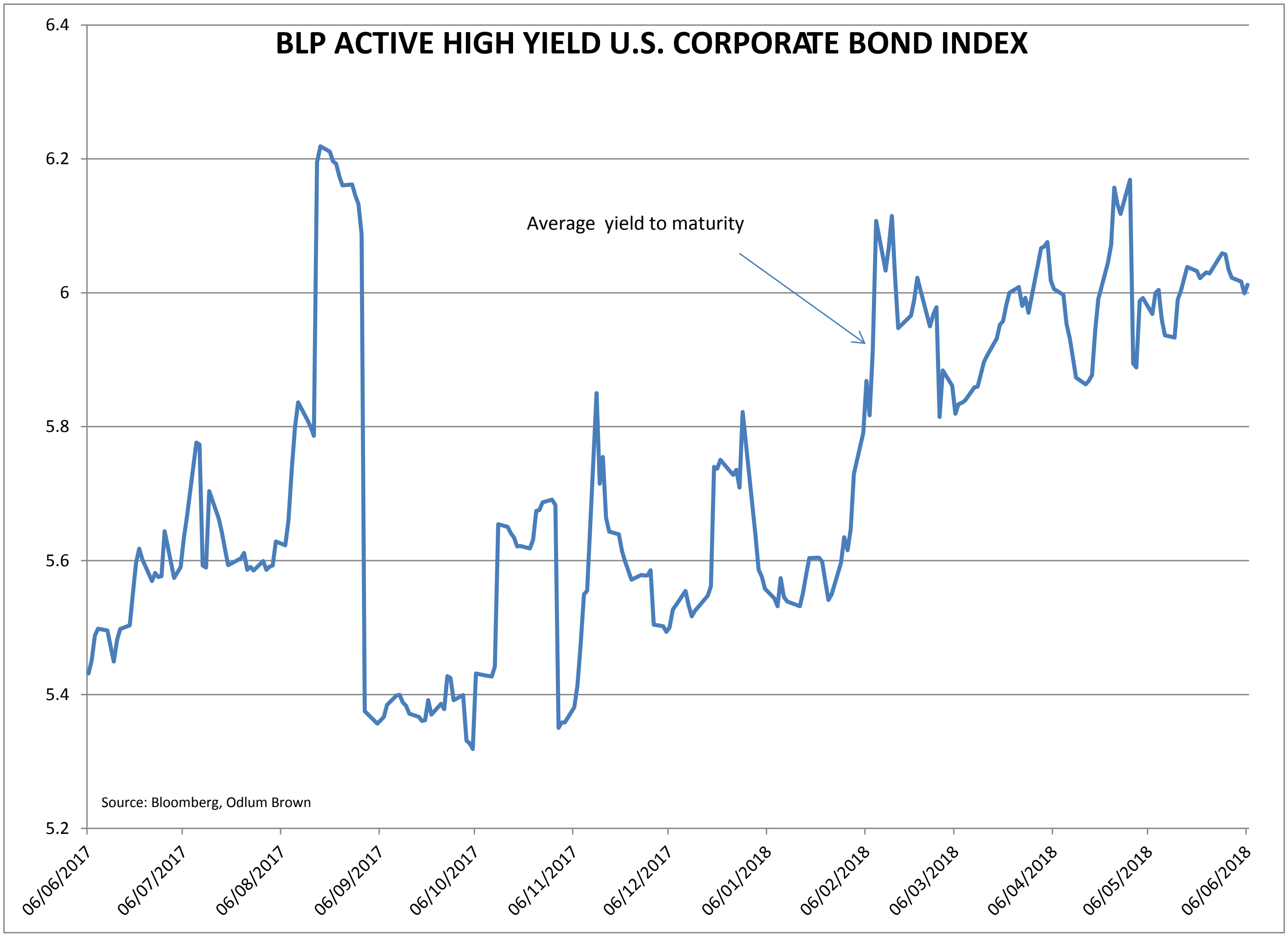
The yield on this bellwether bond has risen back to the important 3% level. The support level is at 2.63% and resistance is at 3.03%.



The price of this long-term Canada bond rallied in the past month, moving up as far as the 200-day moving average. An abrupt reversal has pushed its price below the support line.



After dipping briefly, inflation expectations have moved up sharply.



The high yield market remains stable as yields consolidate at 6%. This market is vulnerable to further increases in Treasury yields.

Outlook

The uptrend in bond yields should resume which means an unattractive risk/reward for longer-dated bonds. Indeed, this is happening as the U.S. ten-year has tacked on 13 basis points since month-end and is just short of 3%.

Short-term yields in North America will likely continue to rise as the Federal Reserve has left little doubt that it will move the Fed Funds Rate closer to "normal." The U.S. economy continues to exhibit strength in most sectors, as witness the most recent employment report. Inflation is also showing early signs of modest acceleration. At the margin, the likelihood of the ECB ending its quantitative easing bond purchase program will exert upward pressure on North American bond yields.

The strength of the U.S. economy, combined with heavy issuance of U.S. Treasury bills, notes and bonds plus the monthly runoff from the Fed's balance sheet, should push bond yields back over 3% with a 3.25% rate likely.

The odds of a recession occurring in the next two years, while considered low by consensus, are increasing as a result of higher corporate leverage and rising interest rates and bond yields. Thus, while credit markets, both investment-grade and high yield, are healthy at present, there is the growing possibility of deterioration in corporate credit health.

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 further 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 any possible 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.