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INVESTMENT RESEARCH

MONTHLY FIXED INCOME UPDATE

Hank Cunningham **March 10, 2017**

Interest Rate Summary	28-Feb-17	30-Dec-16	31-Dec-15	31-Dec-14	31-Dec-13	31-Dec-12
U.S.						
3-Month T-Bill	0.61%	0.50%	0.16%	0.04%	0.07%	0.04%
2-Year Treasury	1.26%	1.19%	1.31%	0.47%	0.38%	0.25%
10-Year Treasury	2.39%	2.44%	2.27%	2.17%	3.03%	1.76%
Canada						
3-Month T-Bill	0.50%	0.45%	0.51%	0.90%	0.92%	0.92%
2-Year Canada	0.76%	0.74%	0.48%	0.99%	1.14%	1.14%
10-Year Canada	1.63%	1.72%	1.39%	1.86%	2.76%	1.80%

Performance

	Feb-2017	Year-to-Date	2016	2015	2014	2013	2012
DEX Universe Bond Index	0.96%	0.83%	3.52%	3.52%	8.79%	-1.19%	2.65%
DEX Federal Bond Index	0.59%	0.45%	3.66%	3.66%	6.91%	-1.52%	2.111%
DEX Provincial Bond Index	1.30%	0.77%	4.14%	4.14%	12.18%	-2.70%	
DEX All Corporate Index	0.99%	1.40%	2.71%	2.71%	7.58%	0.84%	6.22%
DEX “A” Corporate Index	1.20%	1.42%	2.62%	2.62%	9.10%	-0.16%	6.85%
DEX Real Return Bonds	0.82%	-1.09%	2.79%	2.79%	13.18%	-13.1%	
DEX High Yield Bonds	0.99%	3.14%					

Comments:

Performance was positive in all sectors of the bond market in February. Investment-grade and high-yield corporate bonds continued to outperform governments.

The U.S. ten-year note finished the month five basis points lower at 2.39% after dropping to as low as 2.32%.

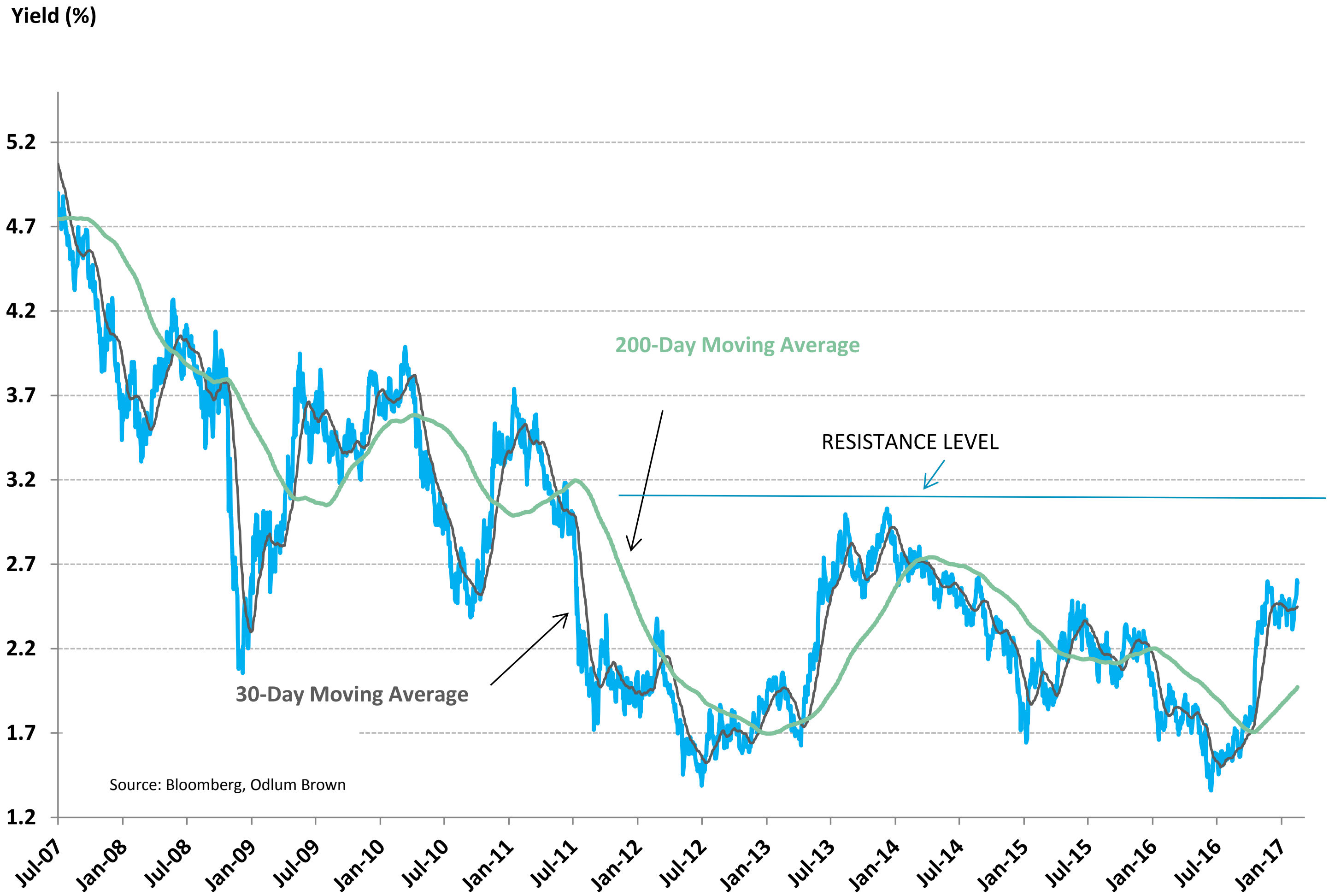
While the month began with a solid increase of 227,000 non-farm jobs in the U.S., the bond market focused on the dip in wage growth. The Fed chipped in with a bland, non-hawkish statement.

The bloom came off the Trump reflation trade as the reality is setting in that any of his pro-growth policies will take time to implement and add only marginally to GDP this year.

In mid-month, Fed Chair Yellen offered more upbeat testimony to Senate and Congress, suddenly moving the odds higher for an increase in the Fed Funds Rate in March. These odds moved close to 100% as the month wore on and key components of growth, namely consumer spending and sentiment, the housing market, and business spending, continued to exhibit momentum. The latest employment report in early March, exceeded consensus again, sealing the fate for the Fed Funds hike expected on March 15, 2017.

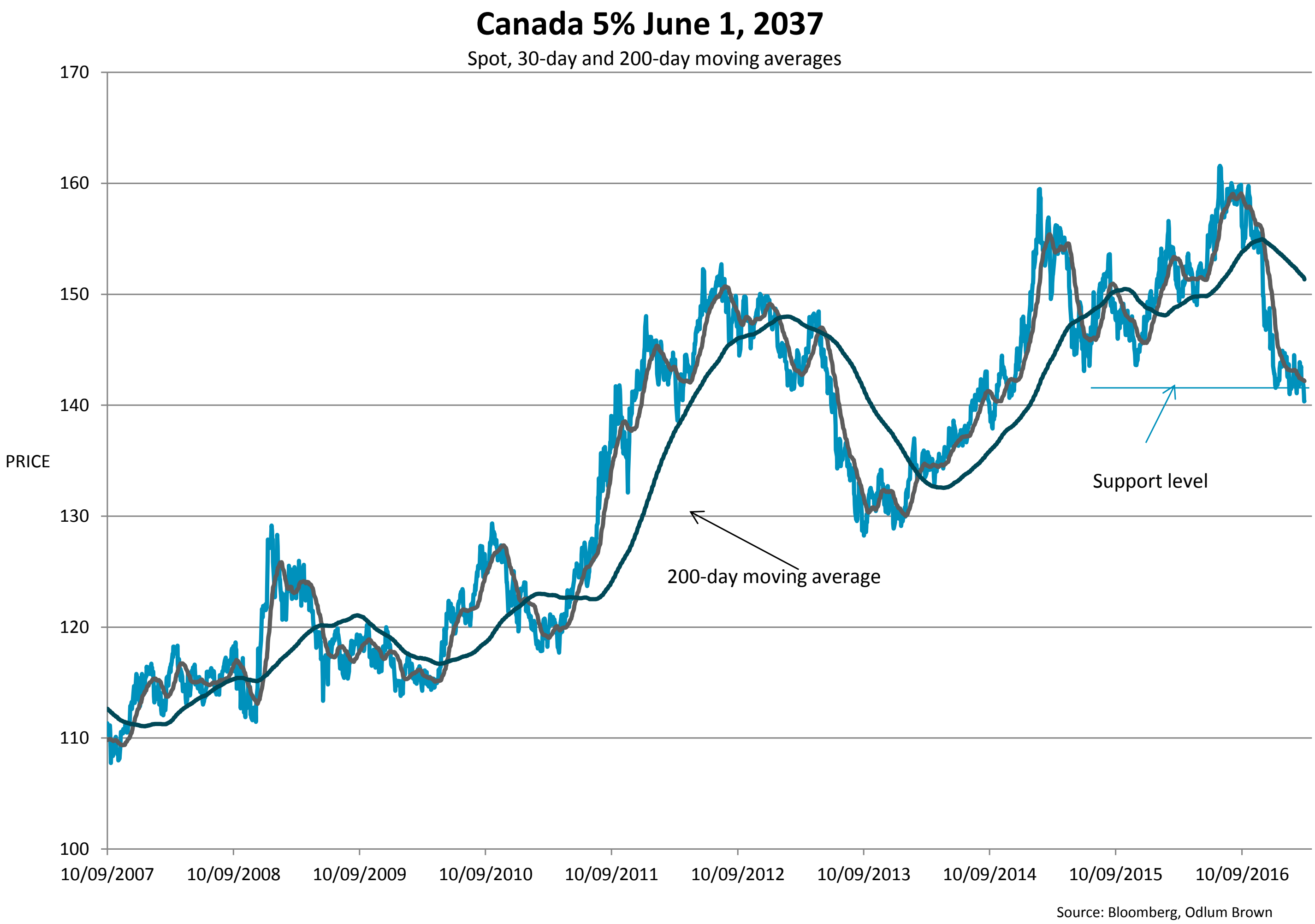
Canada’s economy is matching the growth of the U.S. economy, thanks to a string of positive news in the areas of employment, merchandise trade, home and auto sales, and consumer spending and confidence. Canada’s real GDP growth appears headed for a pace of 2.5%.

U.S. 10-Year Treasury

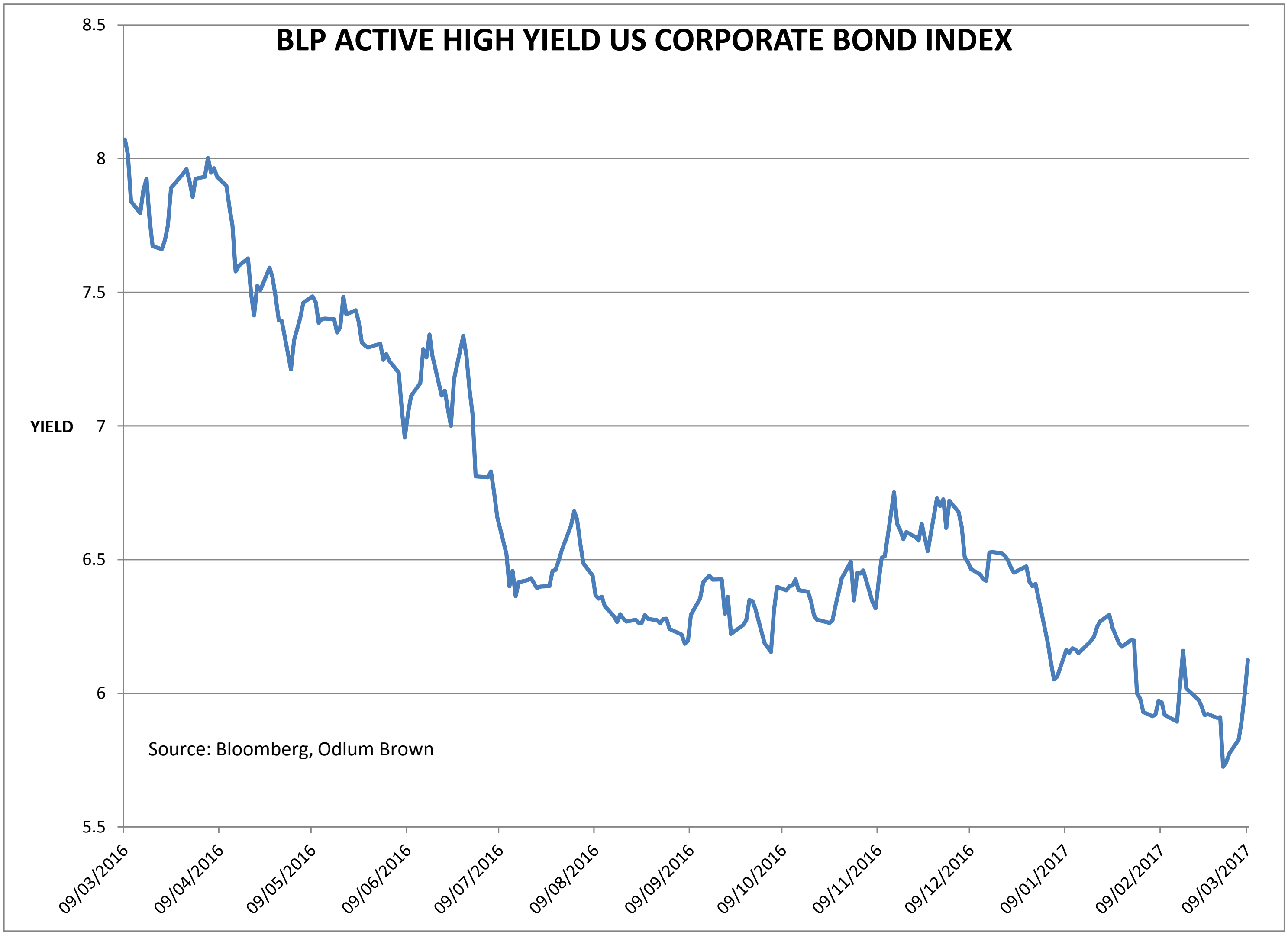


Source: Bloomberg, Odlum Brown

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 has plummeted and has broken a key support level.



High-yield bonds are rising in yield in response to rising Government yields.

Outlook

The global economy has entered a phase of synchronized, albeit weak, growth, which has yet to be accompanied by rising inflation. Now that market analysts are correctly downgrading the reflation effects of Trump's initiatives, growth estimates for the U.S. have settled into the 2.5% range.

The Federal Reserve is poised to raise the Fed Funds Rate on March 15 and perhaps three more times this year given current trends. Longer-term bond yields should continue to rise. It is possible to see some downward pressure on bond yields for the same reasons as in the recent past, namely, demographics, the debt overhang and weak growth and inflation. However, we feel that the odds favour the ten-year U.S. Treasury note reaching 3% this year as the employment market tightens further and as wage inflation exhibits some upside.

The Canadian economy is also forecast to grow at 2.5% in 2017. The Bank of Canada has remained dovish thus far, but as both short-term and long-term U.S. yields continue to rise, our yields will be dragged higher and the Bank of Canada will have to move away from its accommodative stance.

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 are near their lows in yield for the past twelve months 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.