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INVESTMENT RESEARCH

MONTHLY FIXED INCOME UPDATE

Hank Cunningham

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Interest Rate Summary	28-Feb-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	1.66%	1.38%	0.50%	0.16%	0.04%	0.07%	0.04%
2-Year Treasury	2.25%	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	1.14%	1.05%	0.45%	0.51%	0.90%	0.92%	0.92%
2-Year Canada	1.79%	1.69%	0.74%	0.48%	0.99%	1.14%	1.14%
10-Year Canada	2.23%	2.04%	1.72%	1.39%	1.86%	2.76%	1.80%

Performance

	Feb-2018	2017	2016	2015	2014	2013	2012
DEX Universe Bond Index	0.15%	2.52%	3.52%	3.52%	8.79%	-1.19%	2.65%
DEX Federal Bond Index	0.36%	0.13%	3.66%	3.66%	6.91%	-1.52%	2.11%
DEX Provincial Bond Index	0.04%	4.33%	4.14%	4.14%	12.18%	-2.70%	
DEX All Corporate Index	0.02%	3.38%	2.71%	2.71%	7.58%	0.84%	6.22%
DEX “A” Corporate Index	-0.06%	4. 42%	2.62%	2.62%	9.10%	-0.16%	6.85%
DEX Real Return Bonds	0.31%	0.72%	2.79%	2.79%	13.18%	-13.1%	
DEX High Yield Bonds	N.A.	9.94%					

Comments:

Performance was mildly positive in most sectors of the bond market in February. U.S. yields rose by more than Canadian yields at three month, two- and ten-year maturities by five basis points across the board.

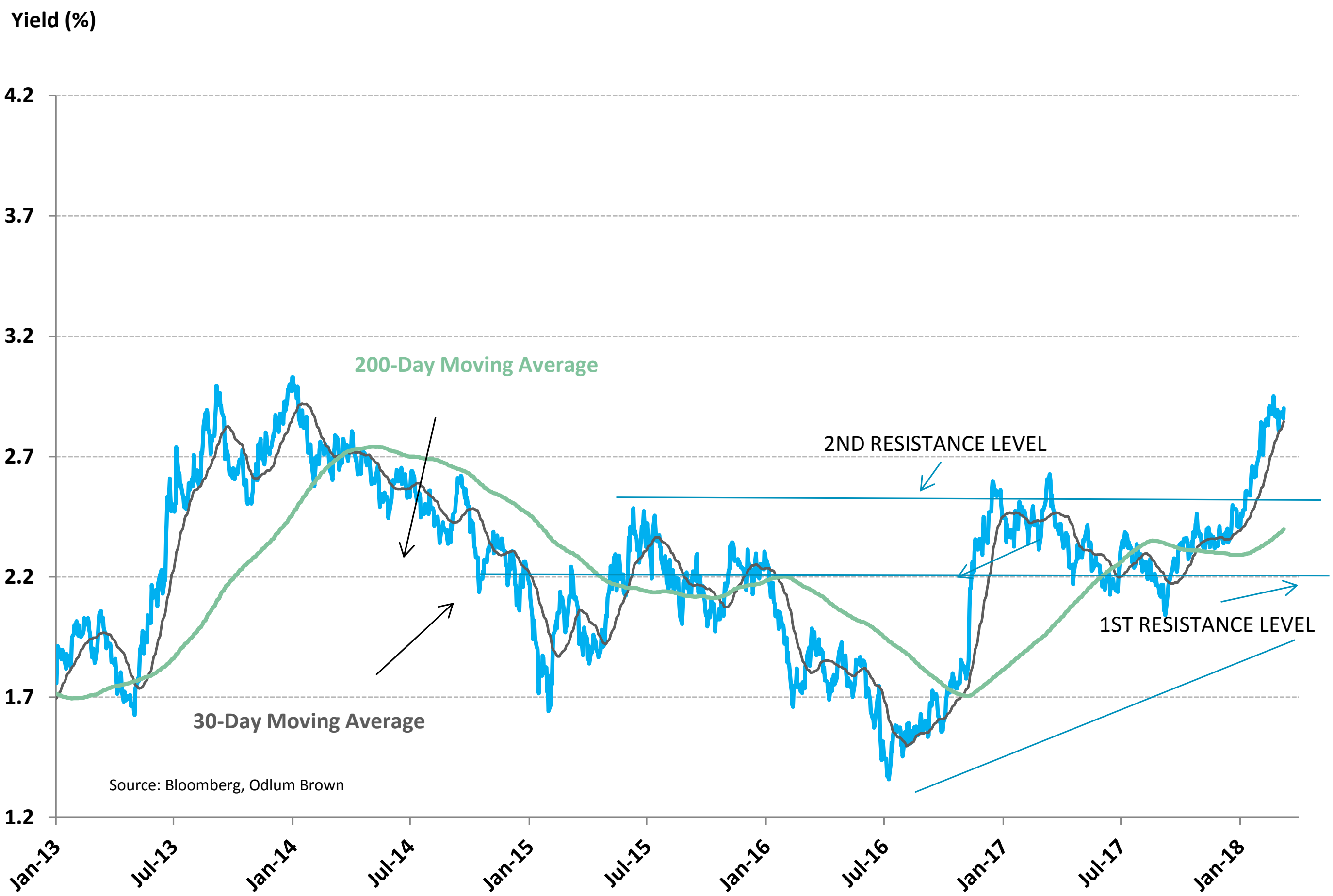
February saw a continuation of this year’s bear trend as the yield on the bellwether ten-year note hit 2.95% on February 21. The following factors identify the sources of rising bond yields:

- Growing global economic growth – world growth reached 4% in Q3
- Solid economic performance in the U.S. in almost all sectors – employment, housing, construction, manufacturing, exports, consumer spending and optimism, and vehicle sales
- Uptick in inflation was modest but has reached 2% year-over-year
- Buoyant labour market – wages advanced in the U.S. by 2.9% year-over-year, the most rapid pace since 2009. They recently ebbed to a 2.6% rate year-over-year
- Increased supply – the combination of the increased deficit plus the run-off from the Federal Reserve’s balance sheet means that there will be an extra $500 billion of new U.S. Treasury supply

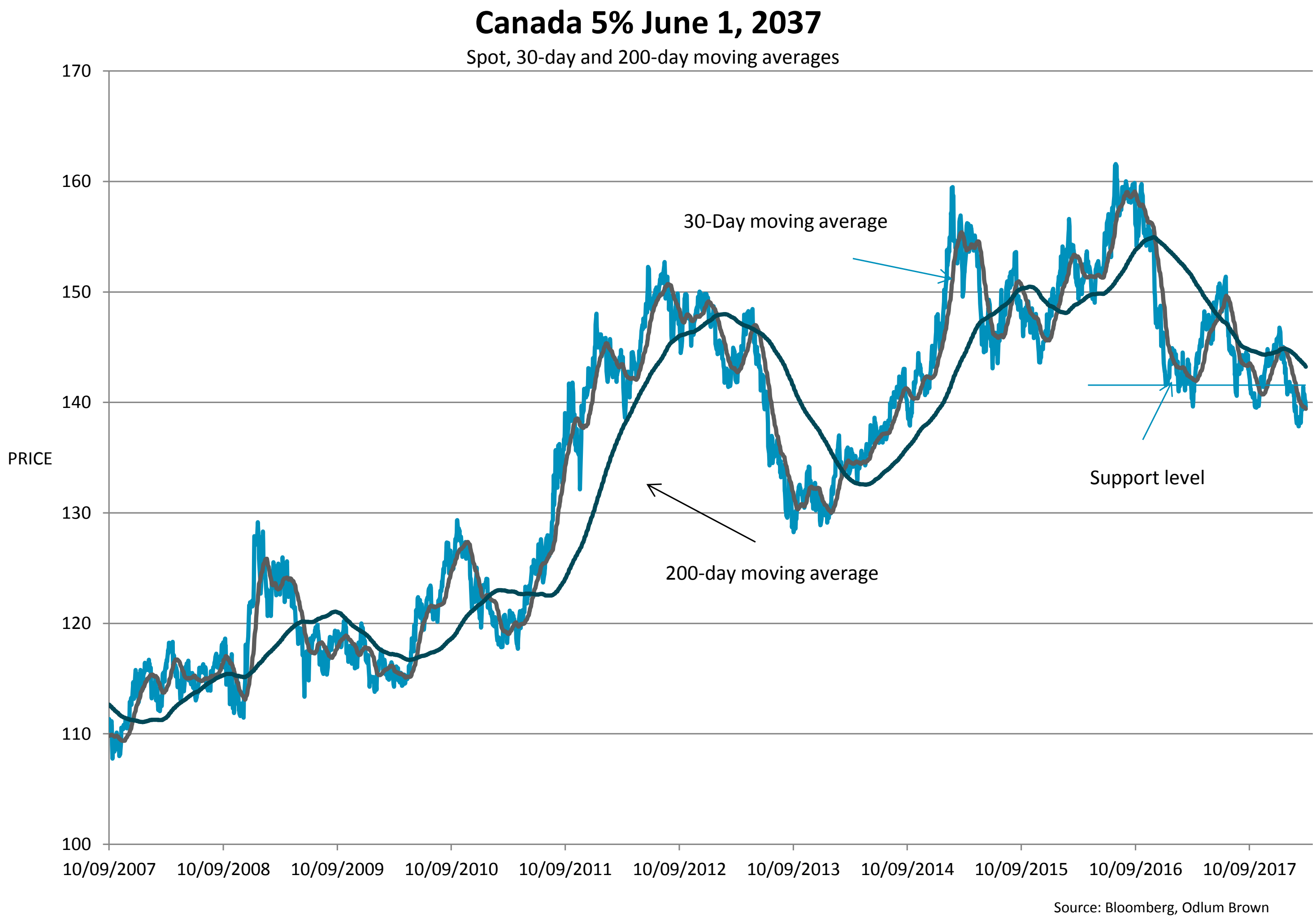
While the Federal Reserve stood pat, the incoming Fed Governor Jerome Powell left little doubt that the Fed would continue to normalize rates this year. The market now assumes that he will raise the Fed Funds Rate four times.

As for Canada, the bloom has come off our economic picture as the housing market weakened from record levels, export growth has been sluggish and business investment has been weak. Nevertheless, the Bank of Canada is upbeat on our economy. The loonie came under downward pressure in the wake of the tariff turmoil but should at least stabilize with such positive factors as our fiscal strength, the U.S. expansion, global growth and firming commodity prices.

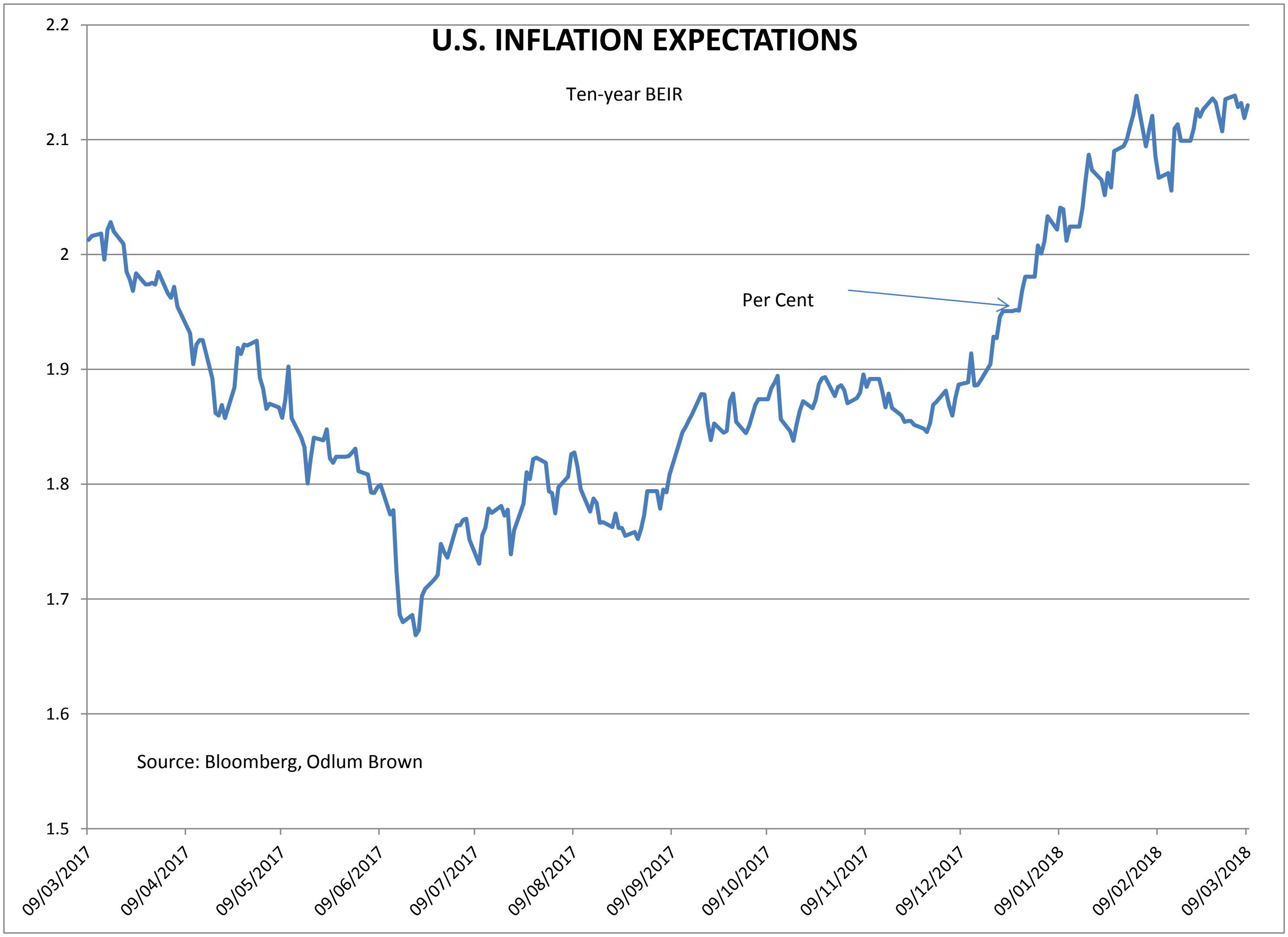
U.S. 10-Year Treasury



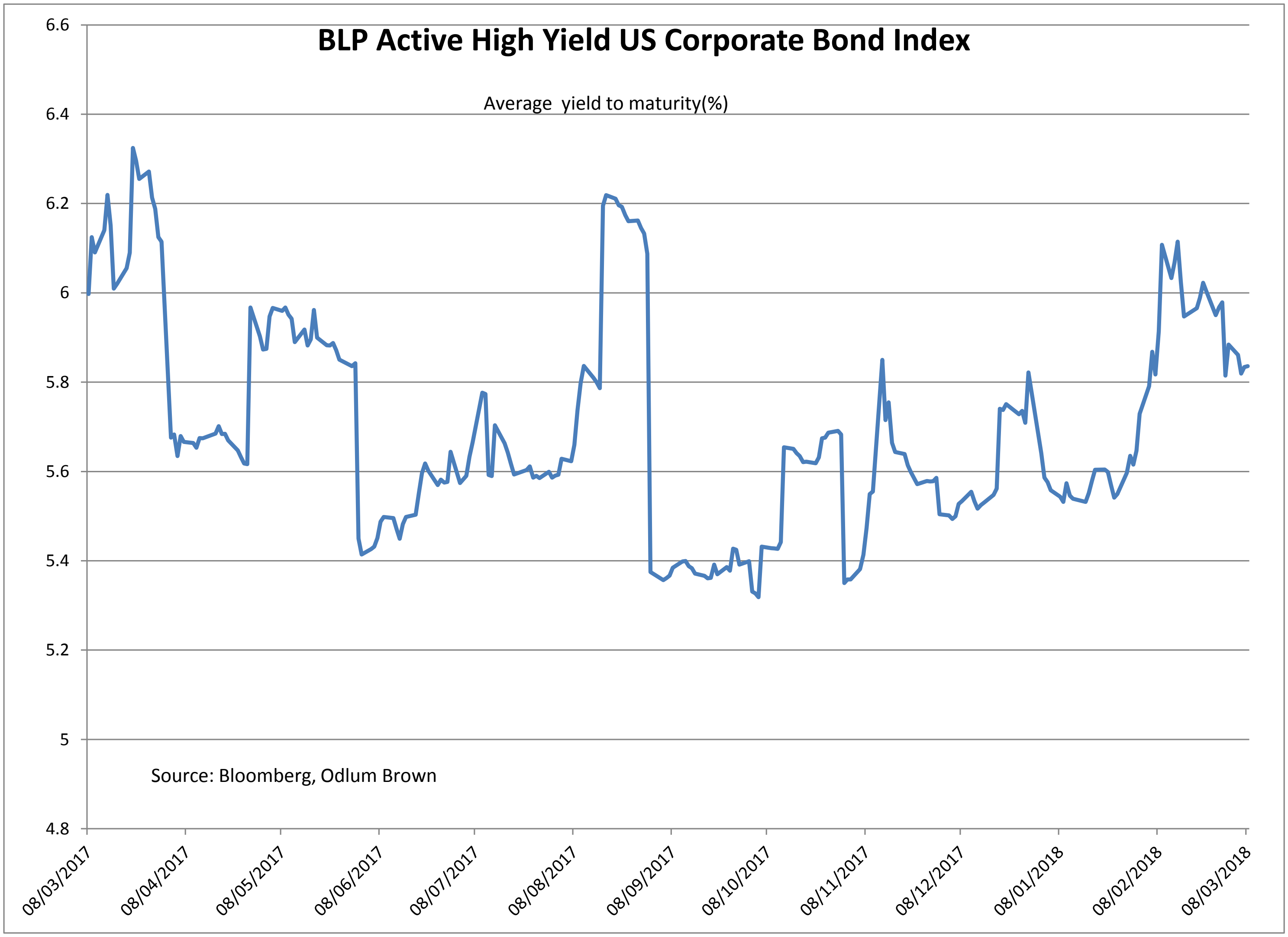
The yield on this bellwether bond has stabilized just below the psychologically important 3% level.



The price of this long-term Canada bond has sold off sharply and remains below the previous support line, which now serves as resistance.



Inflation expectations have moved solidly above 2%.



The high yield market has stabilized following the sharp rise in yields earlier in the year and after significant redemptions.

Outlook

Despite the distraction caused by proposed tariffs and the accompanying threats to economic growth and inflation, there is little to alter our view that short-term interest rates and bond yields are headed higher. The incoming Federal Reserve Chairman, Jerome Powell, testified that the U.S. economy had strengthened in recent months and he left little doubt that the Fed would raise the Fed Funds rate at least three times in 2018.

The employment market is tight with some modest wage pressures emerging. This was underscored by the most recent employment report, which showed a dramatic increase in employment accompanied by low wage gains.

Combined with the extra $500 billion to be raised in the bond market this year as a result of the tax cuts, it seems likely that market yields will rise. Yields in the U.S. remain among the highest in the developed world; this has prevented bond yields from moving higher than they already have. ECB Chairman Mario Draghi holds one of the important keys for the direction of bond yields. Should he decide to temper his quantitative easing (QE) program of massive bond buying somewhat earlier than projected, we would see prompt increases in market yields in the U.S. In his most recent policy announcement, Draghi removed his easing bias but left his QE program unchanged.

Canada faces a different outlook. While positives remain for the economy, there are some negatives as listed in the comments above and they have come to bear on our currency. Current consensus is for the Bank of Canada to raise its Overnight Rate only twice and only after the Fed takes action. Thus, both administered rates and market yields will rise more slowly in Canada than in the U.S. Recently, the Bank of Canada left its key rate unchanged but did release an upbeat assessment of the Canadian economy. Thus, the Bank's reluctance to raise rates has a lot to do with the uncertainty surrounding NAFTA talks.

Strategy

Against this backdrop, it is difficult to foresee anything but modest to negative 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. At present, the credit markets are showing few signs of strain despite the abrupt selloff earlier in the year. 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.