Monthly Fixed Income Update

Hank Cunningham **October 10, 2017**

Interest Rate Summary	29-Sep-17	30-Dec-16	31-Dec-15	31-Dec-14	31-Dec-13	31-Dec-12
U.S.						
3-Month T-Bill	1.05%	0.50%	0.16%	0.04%	0.07%	0.04%
2-Year Treasury	1.49%	1.19%	1.31%	0.47%	0.38%	0.25%
10-Year Treasury	2.33%	2.44%	2.27%	2.17%	3.03%	1.76%
Canada						
3-Month T-Bill	1.00%	0.45%	0.51%	0.90%	0.92%	0.92%
2-Year Canada	1.52%	0.74%	0.48%	0.99%	1.14%	1.14%
10-Year Canada	2.10%	1.72%	1.39%	1.86%	2.76%	1.80%

Performance

	Sep-2017	Year-to-Date	2016	2015	2014	2013	2012
DEX Universe Bond Index	-1.32%	0.48%	3.52%	3.52%	8.79%	-1.19%	2.65%
DEX Federal Bond Index	-1.18%	-0.73%	3.66%	3.66%	6.91%	-1.52%	2.11%
DEX Provincial Bond Index	-1.66%	0.92%	4.14%	4.14%	12.18%	-2.70%	
DEX All Corporate Index	-1.09%	1.49%	2.71%	2.71%	7.58%	0.84%	6.22%
DEX "A" Corporate Index	-1.27%	2.14%	2.62%	2.62%	9.10%	-0.16%	6.85%
DEX Real Return Bonds	-1.99%	-2.96%	2.79%	2.79%	13.18%	-13.1%	
DEX High Yield Bonds	0.61%	7.37%					

Comments:

Performance was negative in all sectors of the bond market in September except for high yield corporates. While the Universe Index is slightly positive for the year-to-date, Federal Government bonds are now showing a negative return.

The U.S. ten-year yield rose 21 basis points in September after falling sharply in August and has tacked on another five basis points thus far in October.

	U.S.	Canada	Net Difference
Three month Treasury Bills	+5 basis points	+23 basis points	+18 basis points
Two-year bond yields	+16 basis points	+25 basis points	+9 basis points
Ten-year bond yields	+21 basis points	+25 basis points	+4 basis points

The table above shows how much Canadian yields rose in September compared to their U.S. counterparts.

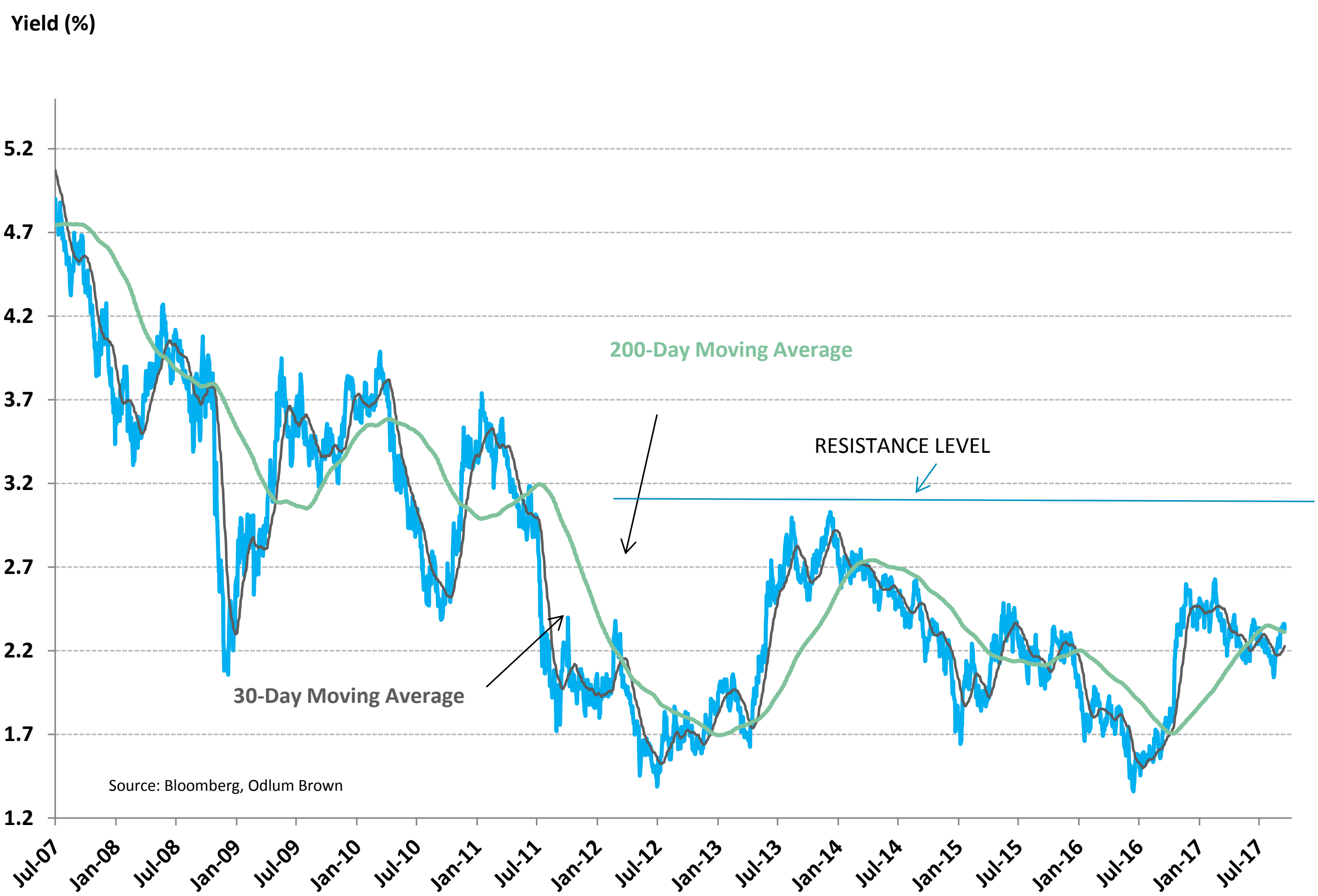
There have been false starts before of bond yields rising in the U.S. What is different this time around is that global yields rose in unison last month. Economic growth in the rest of the world continued to accelerate in a synchronized fashion with even Europe and Japan recording 2% growth year-over-year. While there remains considerable monetary stimulus globally, some Central Banks such as the Bank of Canada and the Bank of Australia are beginning to normalize their policies. ECB head Mario Draghi, while doing nothing but saying a lot, is hinting that he will begin to taper bond purchases soon. The big surprise remains Canada. It reported a strong growth rate of 3.7% for the previous 12 months in what has been a balanced performance for the Canadian economy. The Bank of Canada increased its overnight rate by 25 basis points to 1% on September 6, catching many pundits by surprise. Market yields rose swiftly; two-year, five-year and 10-year Government of Canada bonds have now risen 85, 83 and 65 basis points respectively since early June. Moreover, the Canadian dollar continued to rise, touching $0.825 USD, up 13 % from its lows in May.

As the month wore on, the steam came out of the Canadian economic story, particularly with the second weak trade month in a row, as exports fell. The Loonie slid on this news.

At month-end, there were solid employment reports in the U.S .and Canada. Despite the headline decline in non-farm payrolls, largely a result of the hurricanes, U.S. household employment rose by a whopping 906,000, the unemployment rate fell to 4.2%, and wage gains perked up; increasing by 0.5% for the month and 2.9% year-over-year, the largest increase in eight years.

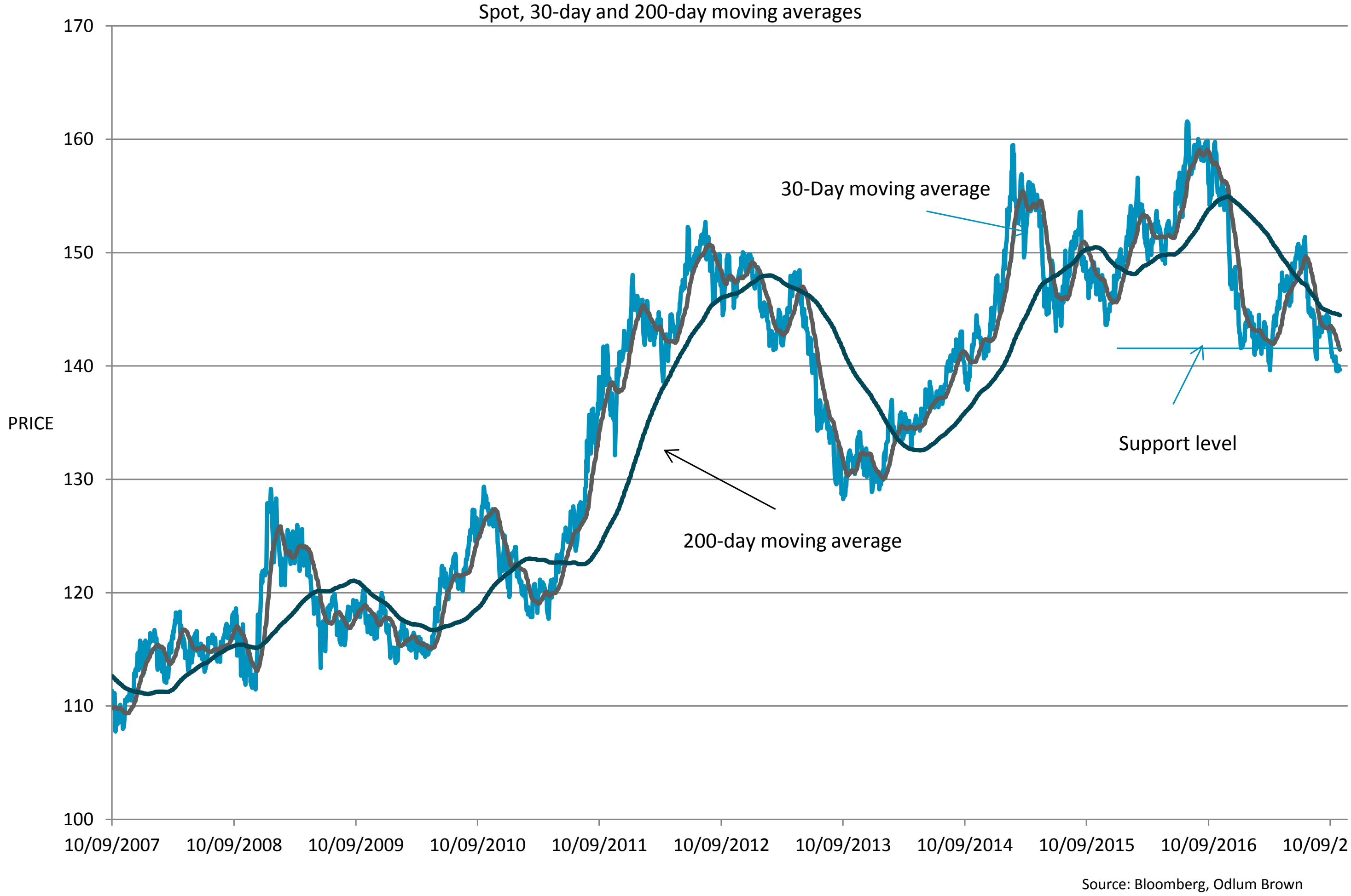
Canada reported an increase of 112,000 full-time jobs, a decline of one-tenth in the unemployment rate and year-over-year wage growth of 2%.

U.S. 10-Year Treasury

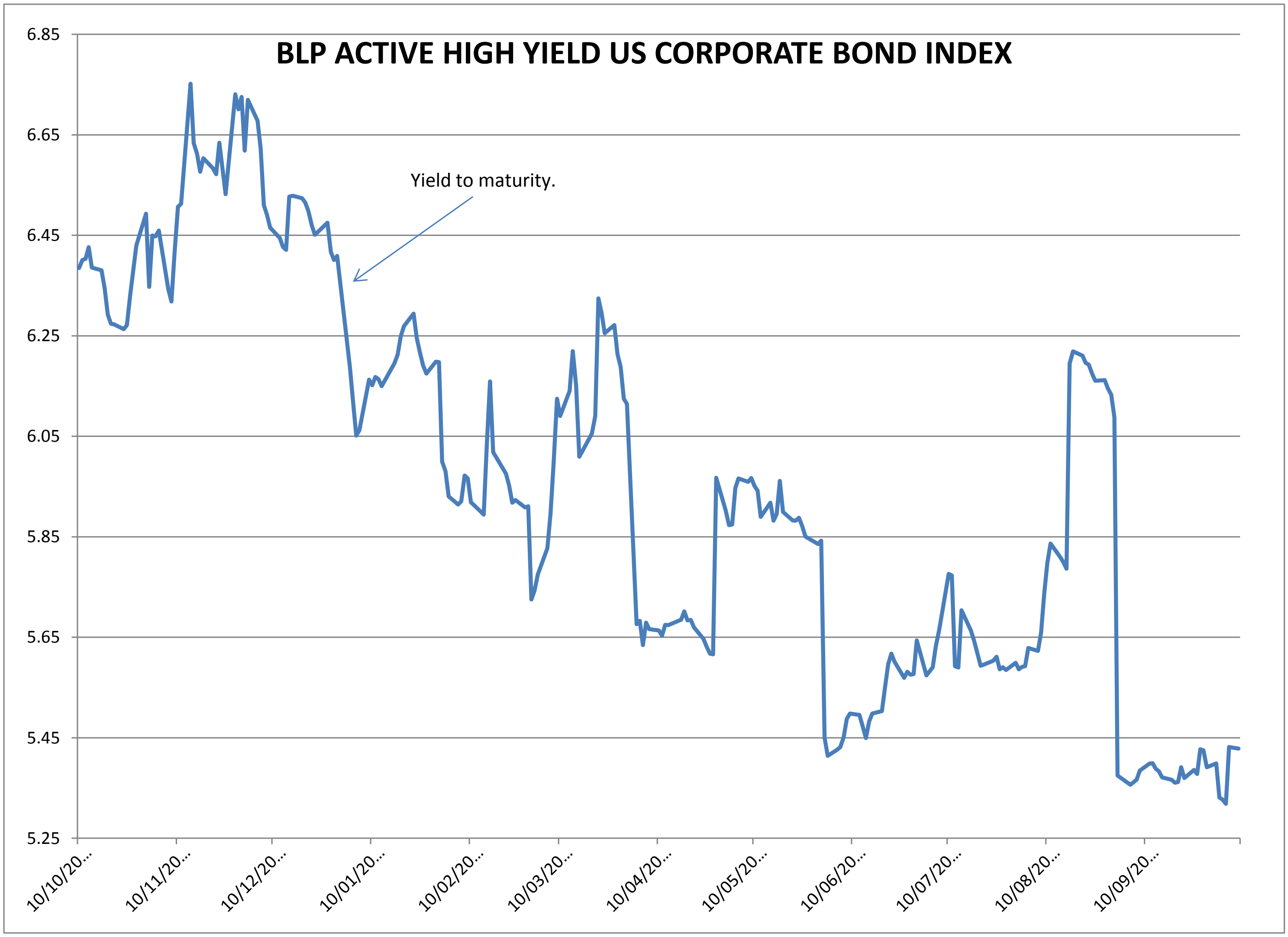


This bond approached, but did not break below 2%. It continues to be locked in a narrow trading range with an upward bias.

Canada 5% June 1, 2037



The price of this long-term Canada bond fell sharply, actually falling below an important support line.



High-yield bonds have risen just modestly in the past four months.

Outlook

The stage is set for further normalization of interest rates. It is likely that both the Federal Reserve and the Bank of Canada will raise their official rates before year-end. Moreover, the Fed's unwinding of its bloated balance sheet begins this month with a net run-off of $10 billion.

With synchronized global economic growth now accompanied by signs of inflation, bond yields should move higher; perhaps challenging the highs for the year, or another 25 basis points. Geopolitical concerns are omnipresent, so there remains the prospect of safe-haven rallies in government bonds.

Thus far, corporate bond yields have not widened measurably, but they will move at least lockstep with government yields.

Strategy

Fixed income investors face the prospect of negative total returns for this year and, as the path of least resistance is towards higher yields, the total return outlook is not encouraging. Ten-year Canada bond yields have more than doubled this year while two-year Canada yields have more than tripled.

Thus, we favour a shorter duration of close to two years where capital will be better protected.

The high-yield market has been relatively immune to the recent rise in bond yields and should continue to produce positive, albeit modest total returns.