



MONTHLY FIXED INCOME UPDATE

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August 8, 2018

Interest Rate Summary	Jul-31-18	29-Dec-17	30-Dec-16	31-Dec-15	31-Dec-14	31-Dec-13	31-Dec-12
U.S.							
3-Month T-Bill	2.02%	1.38%	0.50%	0.16%	0.04%	0.07%	0.04%
2-Year Treasury	2.67%	1.89%	1.19%	1.31%	0.47%	0.38%	0.25%
10-Year Treasury	2.96%	2.41%	2.44%	2.27%	2.17%	3.03%	1.76%
Canada							
3-Month T-Bill	1.44%	1.05%	0.45%	0.51%	0.90%	0.92%	0.92%
2-Year Canada	2.07%	1.69%	0.74%	0.48%	0.99%	1.14%	1.14%
10-Year Canada	2.31%	2.04%	1.72%	1.39%	1.86%	2.76%	1.80%

Performance

	Jul-2018	2017	2016	2015	2014	2013	2012
DEX Universe Bond Index	-0.74%	2.52%	3.52%	3.52%	8.79%	-1.19%	2.65%
DEX Federal Bond Index	-0.63%	0.13%	3.66%	3.66%	6.91%	-1.52%	2.11%
DEX Provincial Bond Index	-1.04%	4.33%	4.14%	4.14%	12.18%	-2.70%	
DEX All Corporate Index	-0.49%	3.38%	2.71%	2.71%	7.58%	0.84%	6.22%
DEX "A" Corporate Index	-0.78%	4.42%	2.62%	2.62%	9.10%	-0.16%	6.85%
DEX Real Return Bonds	-1.86%	0.72%	2.79%	2.79%	13.18%	-13.1%	
DEX High Yield Bonds	0.27%	5.20%	13.79%	-5.58%	2.64%	6.87%	

Corporate bonds outperformed government bonds for the first time in three months as credit conditions improved.

The U.S. yield curve flattened by a further four basis points as the two-year yield rose by more than the ten-year yield. The Canadian yield curve flattened by a mere two basis points.

Comments

July began with a solid employment report and August began with a similar, though not quite as strong, result. Canada produced similar strength in employment.

On balance, U.S. ten-year yields rose by ten basis points, once again challenging 3%. Economic growth remained solid with the much-heralded Q2 GDP report showing a 4.1% gain, while inflation and wages remained relatively subdued.

July also featured an attack on the Federal Reserve policies by the White House. This unprecedented action flies in the face of the realities that:

1. Interest rates and bond yields are still low
2. The Fed is tightening at a slow pace
3. There is fiscal over-stimulus.

There is little doubt that the Fed will proceed in an independent fashion, as it nudges the Fed Funds Rate closer to a neutral rate. The market is anticipating two more rate hikes this year, with the next one coming in September.

Canada had an encouraging month with strong gains in employment, retail sales and trade. The Canadian dollar sagged to \$ 0.75 USD in late June but bounced to \$ 0.77 USD on this array of good news. The Bank of Canada raised the Bank rate by 25 basis points during the month and the market assumes a further increase in September. Canadian ten-year yields rose more than U.S. ten-year yields but remain meaningfully below their U.S. counterparts.

The Bank of Japan stirred up the market with hints of reducing its monetary accommodation; it tweaked policy by allowing the ten-year bond to trade in a range from 0.0% to 0.2%. In the wake of this news, the ten-year bond soared to 0.1%!

U.S. 10-Year Treasury



Source: Bloomberg, Odlum Brown

The yield on this bellwether bond is approaching an important resistance level.

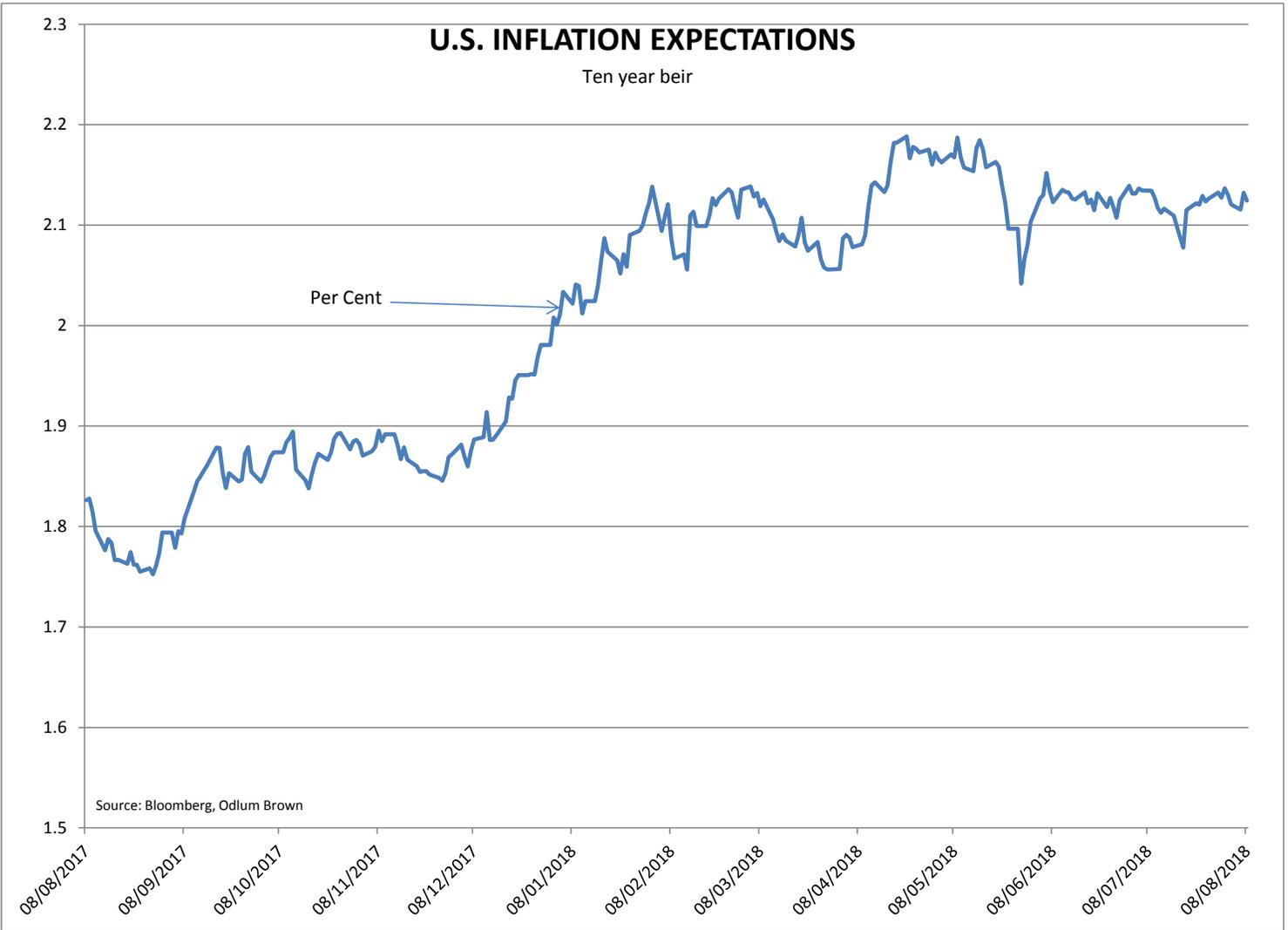
Price (\$)

Canada 5% June 1, 2037

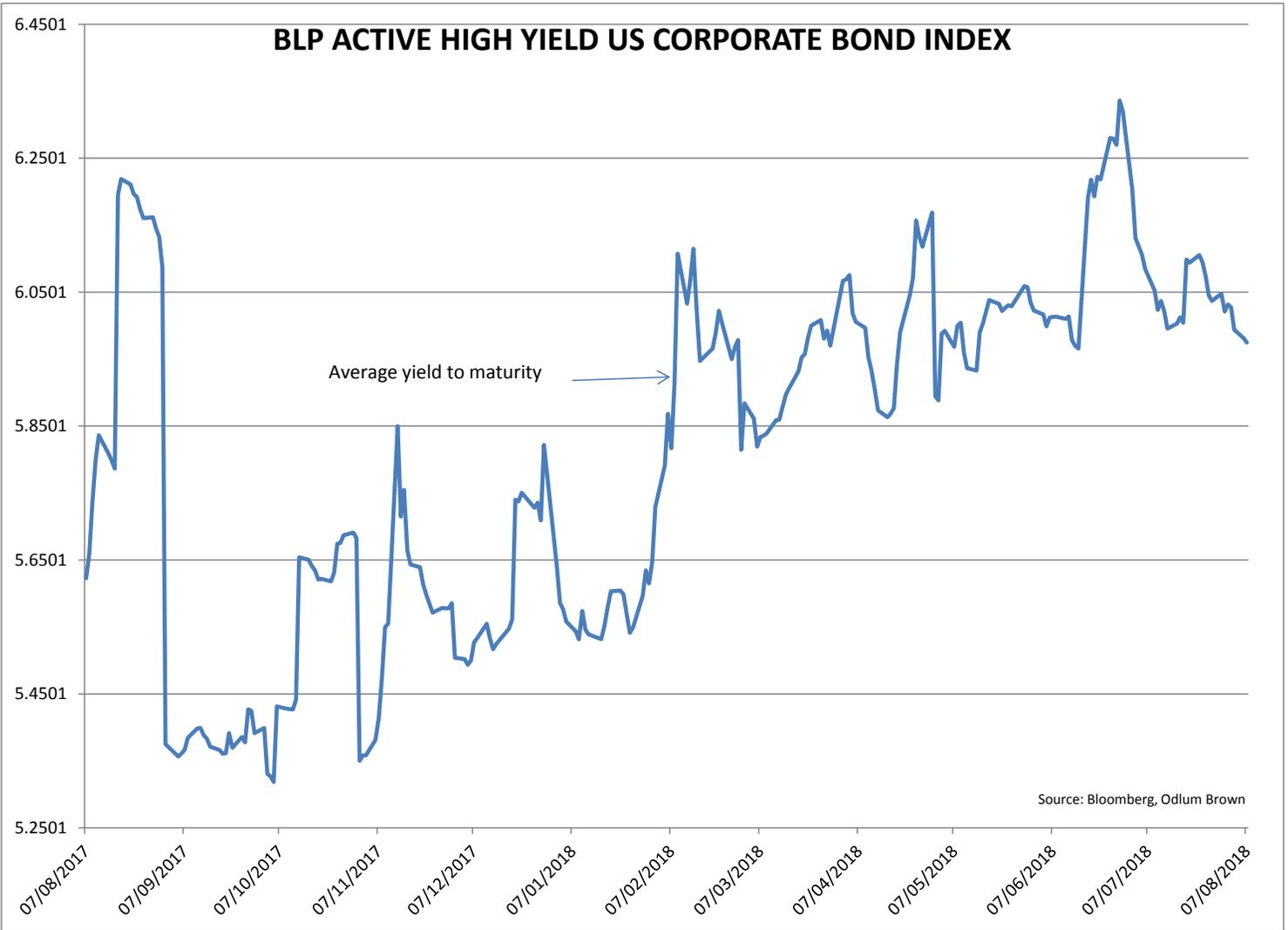


Source: Bloomberg, Odium Brown

The price of this long-term Canada bond sold off sharply last month with momentum falling into negative territory.



After recent increases, inflation expectations have stabilized.



The high yield market continues to improve.

Outlook

We maintain our outlook that U.S. and Canadian bond yields will rise with a near-term target of 3.25% for the U.S. ten-year. While there was some upward movement in global bond yields in July, the yawning gap between those yields (mostly those in the Euro zone) continues to attract safe-haven flows to the U.S. bond market.

There can be little in the way of definitive analysis on the net effect of the tariff impositions on economic growth. At the margin, growth will be less than consensus, while inflation will be higher.

The U.S. credit markets will feel the weight of the burgeoning Federal Deficit. The Treasury announced a significant increase in borrowing for the current quarter with a total issuance of \$78 billion planned with an increased emphasis on longer-term issuance. Combined with the ongoing reduction in the Fed's balance sheet, the net result, again at the margin, will be upward pressure on market yields.

The Federal Reserve will continue its gradual tightening and will be joined by the Bank of Canada.

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 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 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.

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