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INVESTMENT RESEARCH

Monthly Fixed Income Update

Hank Cunningham **December 10, 2018**

Interest Rate Summary	Nov-30-18	29-Dec-17	30-Dec-16	31-Dec-15	31-Dec-14	31-Dec-13	31-Dec-12
U.S.							
3-Month T-Bill	2.35%	1.38%	0.50%	0.16%	0.04%	0.07%	0.04%
2-Year Treasury	2.79%	1.89%	1.19%	1.31%	0.47%	0.38%	0.25%
10-Year Treasury	2.99%	2.41%	2.44%	2.27%	2.17%	3.03%	1.76%
Canada							
3-Month T-Bill	1.69%	1.05%	0.45%	0.51%	0.90%	0.92%	0.92%
2-Year Canada	2.16%	1.69%	0.74%	0.48%	0.99%	1.14%	1.14%
10-Year Canada	2.27%	2.04%	1.72%	1.39%	1.86%	2.76%	1.80%

Performance

	Nov-2018	2017	2016	2015	2014	2013	2012
DEX Universe Bond Index	1.02%	2.52%	3.52%	3.52%	8.79%	-1.19%	2.65%
DEX Federal Bond Index	1.19%	0.13%	3.66%	3.66%	6.91%	-1.52%	2.11%
DEX Provincial Bond Index	1.32%	4.33%	4.14%	4.14%	12.18%	-2.70%	
DEX All Corporate Index	0.43%	3.38%	2.71%	2.71%	7.58%	0.84%	6.22%
DEX "A" Corporate Index	0.59%	4. 42%	2.62%	2.62%	9.10%	-0.16%	6.85%
DEX Real Return Bonds	-0.51%	0.72%	2.79%	2.79%	13.18%	-13.1%	
DEX High Yield Bonds	-0.95%	5.20%	13.79%	-5.58%	2.64%	6.87%	

Government bonds outperformed corporate bonds handily in November as yield spreads widened significantly. Real Return and High Yield Bonds produced negative returns.

Comments

On November 8, two-year U.S. Treasuries touched 2.97% and the ten-year note reached 3.24%; this was the second time at that yield for the ten-year, having also reached it on October 17.

These two bonds closed out November at 2.77% and 2.99% respectively. Since then, their yields have fallen even further, and are now at 2.73% and 2.85%. Two-year bonds yield more than five-years and the spread between two-years and ten-years has narrowed to an almost-flat 12 basis points. Investment grade corporate bonds widened significantly in yield from government bonds, while high yield bonds produced negative returns.

What happened?

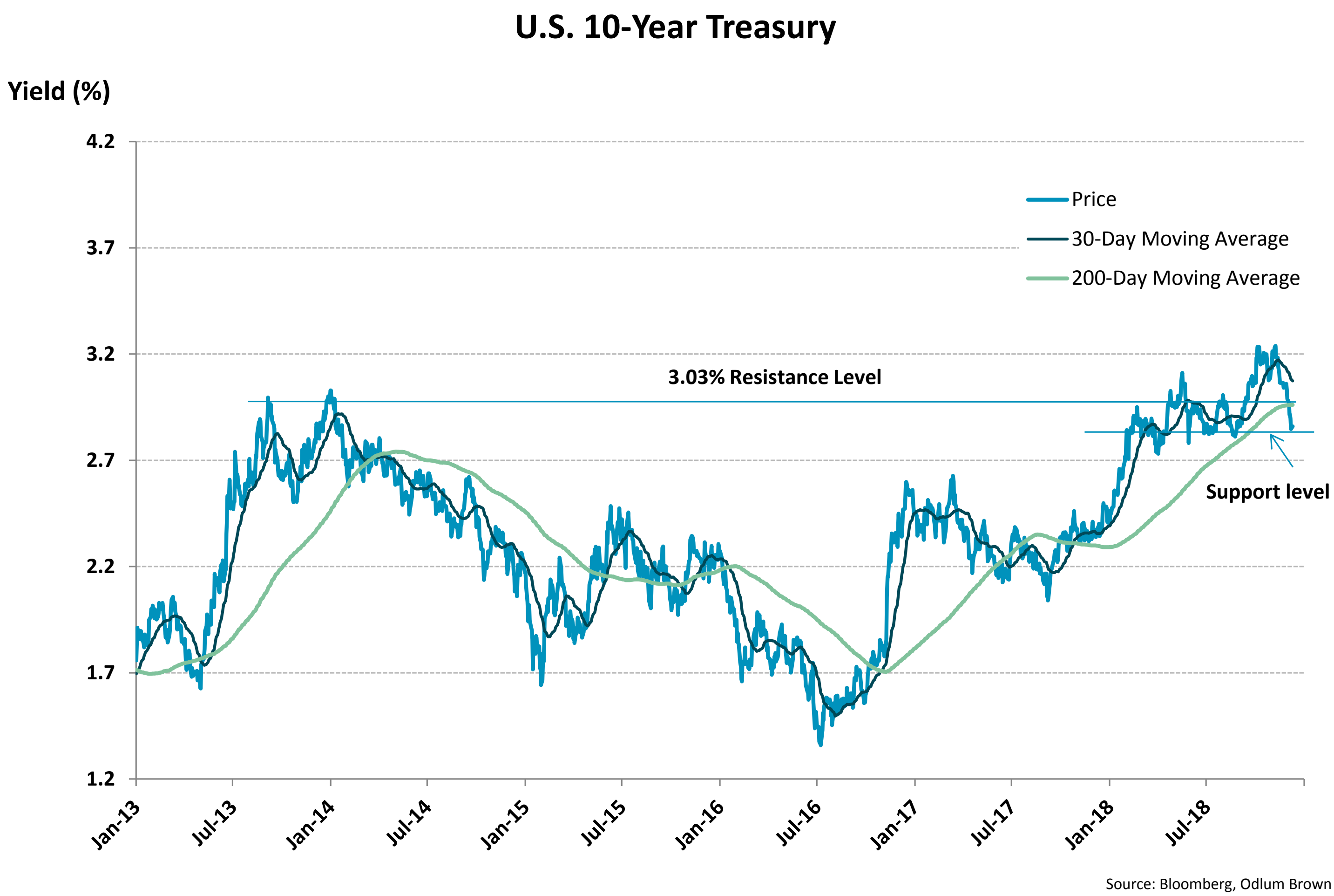
A number of factors contributed to this startling turnaround:

1. Slowing global growth, most notably in the Euro area and Japan.
2. Slowing in the interest-sensitive sectors of the U.S. economy, particularly the housing market and vehicle sales.

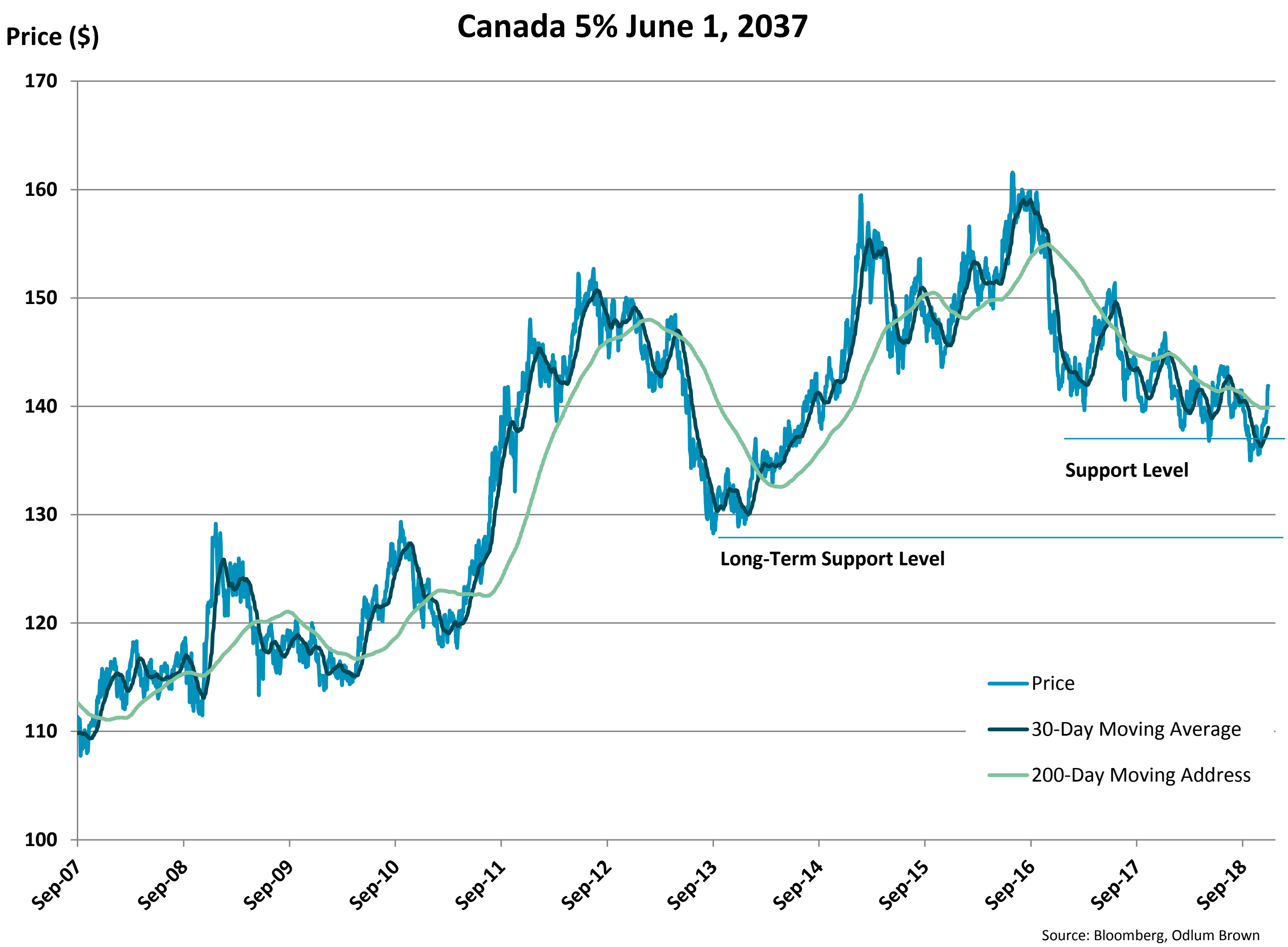
3. Reduction in estimates for the U.S. economy from the Federal Reserve Chairman Powell, reining in future rate hike expectations.
4. Soft inflation readings such as the important core PCE, and no upward pressure on wages.
5. A re-emergence of deflationary pressures, not only in energy prices, but also in the broader commodity price structure.
6. Growing concern over trade issues.
7. Credit market worries about potential downgrades.
8. Weakness in equity markets.

In Canada, following its most recent rate hike on October 24 and accompanying positive outlook, the Bank of Canada left its key lending rate unchanged on December 5 and downgraded its outlook significantly in the accompanying press release. The Canadian dollar, already struggling with the effect of weak commodity prices, sagged further.

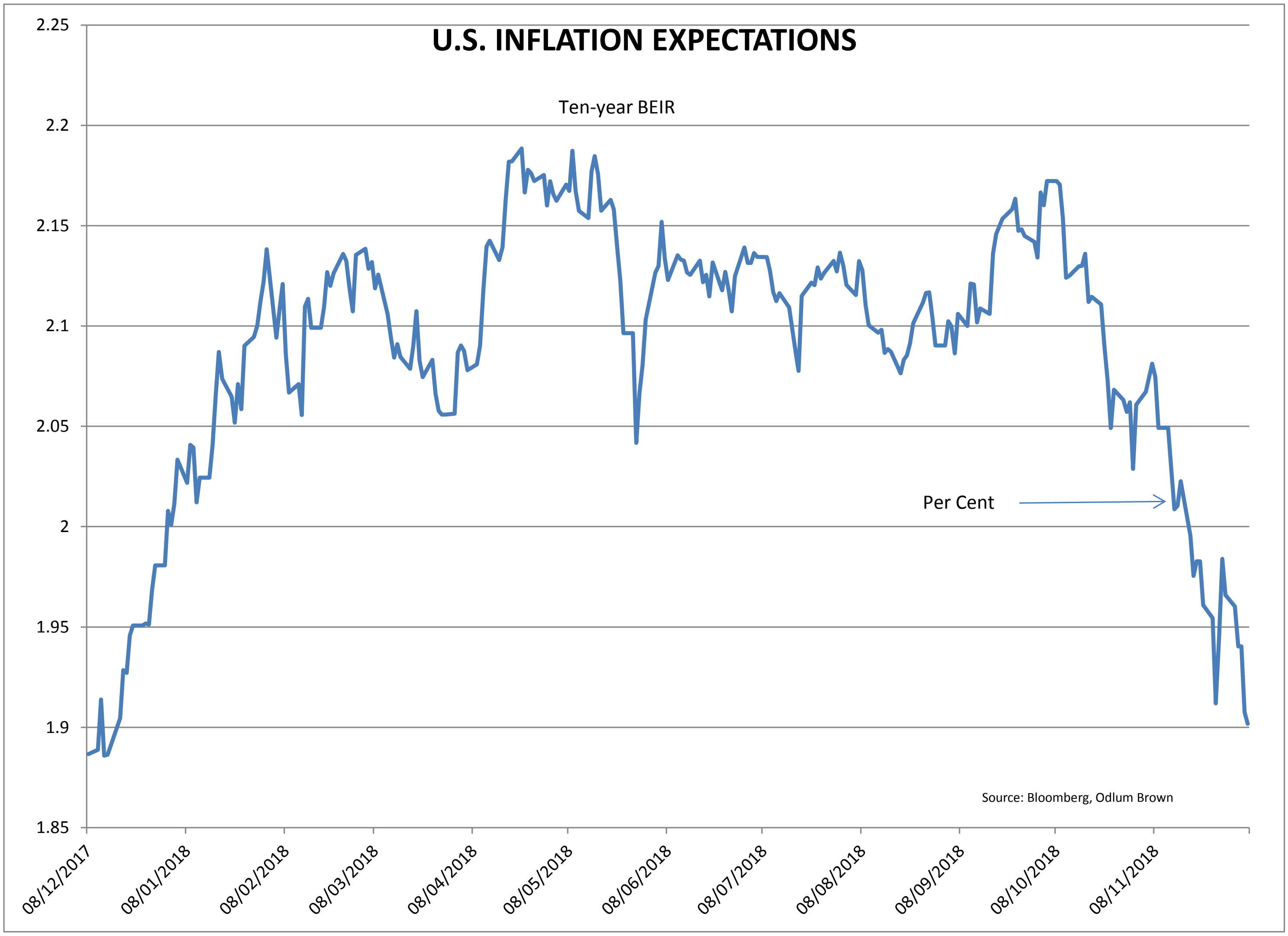
Globally, growth estimates have been pared slightly. The ECB is still expected to end its QE program.



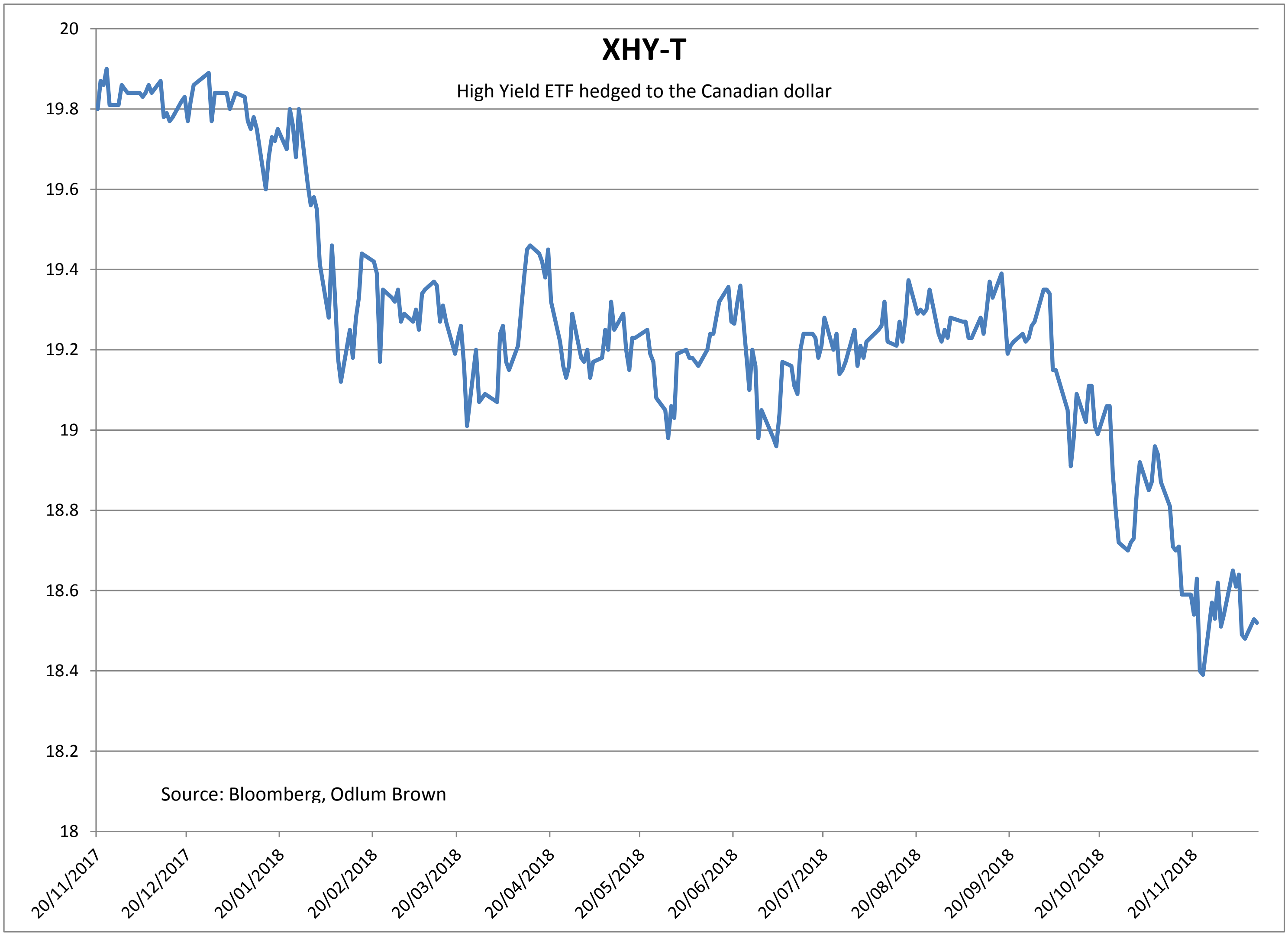
The yield on this bellwether bond reached a double-top at 3.24% and has fallen below the important 200-day moving average.



The price of this long-term Canada bond rebounded from support levels and has moved above its 200-day moving average.



Inflation expectations have softened noticeably.



The high yield market sold off in the past two months.

Outlook

The economic outlook has dimmed during the past two months. Both the Federal Reserve and the Bank of Canada have softened their tone. While the Fed is almost certain to increase the Fed Funds rate in December, it might be the last hike for a while.

There are a host of positives still in place in the U.S. economy:

1. Buoyant retail sales and consumer confidence.
2. Increased business investment and industrial production.
3. Tight labour market.
4. Solid PMIs.

Global growth has been pared slightly by the OECD for 2019 but is still expected to be at 3.4%.

With one more Fed Funds hike coming and with inflation ebbing, the ten-year U.S. bellwether bond yield will not be climbing back to 3.24% anytime soon. That is looking like the market top for now. However, there is not a strong case for bond yields to fall further from current levels either, as a result of all the positive factors still present. Inflation may be ebbing but it is still in the 2% area, leaving real yields barely positive including the Fed Funds rate. The U.S. Treasury had to issue record amounts of bonds to finance the whopping U.S. deficit. With the flatter yield curve, the Treasury may begin to ramp up its issuance of long-term bonds.

Our conclusion is that there is no recession coming soon and that the fears surrounding the corporate credit market, both for investment grade and high yield bonds, are overblown. This is not to ignore them, but even with the recent widening of spreads from government bonds, corporate bond yield spreads are still historically tight. Long-term yields are near the bottom end of what we estimate to be the new trading range of 2.75% to 3.24%.

Strategy

There is little to alter our view of maintaining high-quality, short-duration corporate bond portfolios. Our emphasis remains on quality. Such an approach seems likely to produce medium-term returns in the 3% – 3.5% region; there will be minimal risk to principal. The high yield market may be considered for those clients willing to take on increased credit risk for higher returns. We favour XHY-T, the Canadian dollar-hedged ETF, for that purpose as a result of its totally diversified portfolio. We also continue to recommend selected investment in certain outside investment managers, who have demonstrated consistent returns in credit markets. Floating rate bonds have lost some of their appeal as the Bank of Canada is on the sidelines for the foreseeable future. For further discussion, please speak to your investment advisor.