



## 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
<b>U.S.</b>							
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%
<b>Canada</b>							
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:

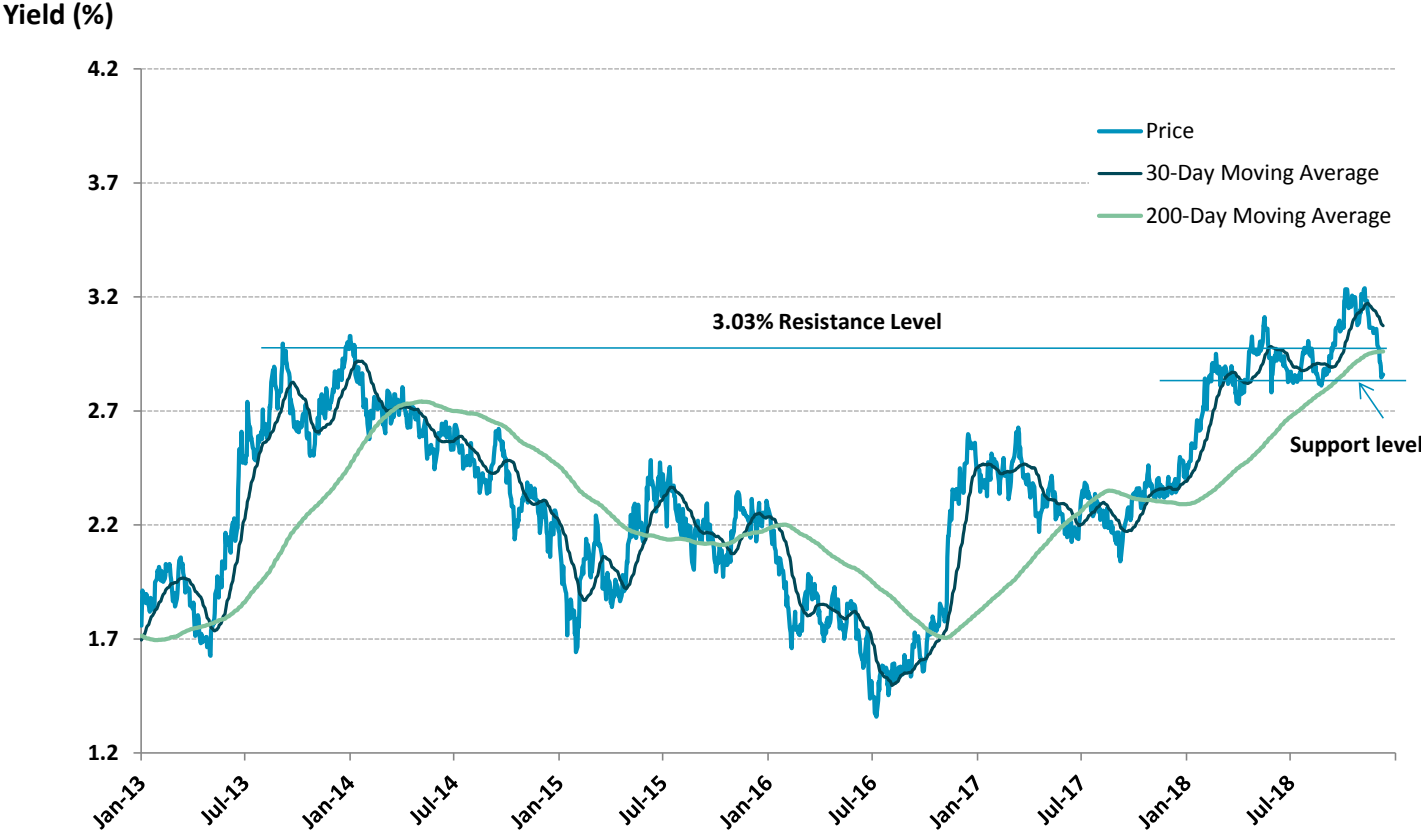
1. Slowing global growth, most notably in the Euro area and Japan.
2. Slowing in the interest-sensitive sectors of the U.S. economy, particularly the housing market and vehicle sales.

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.

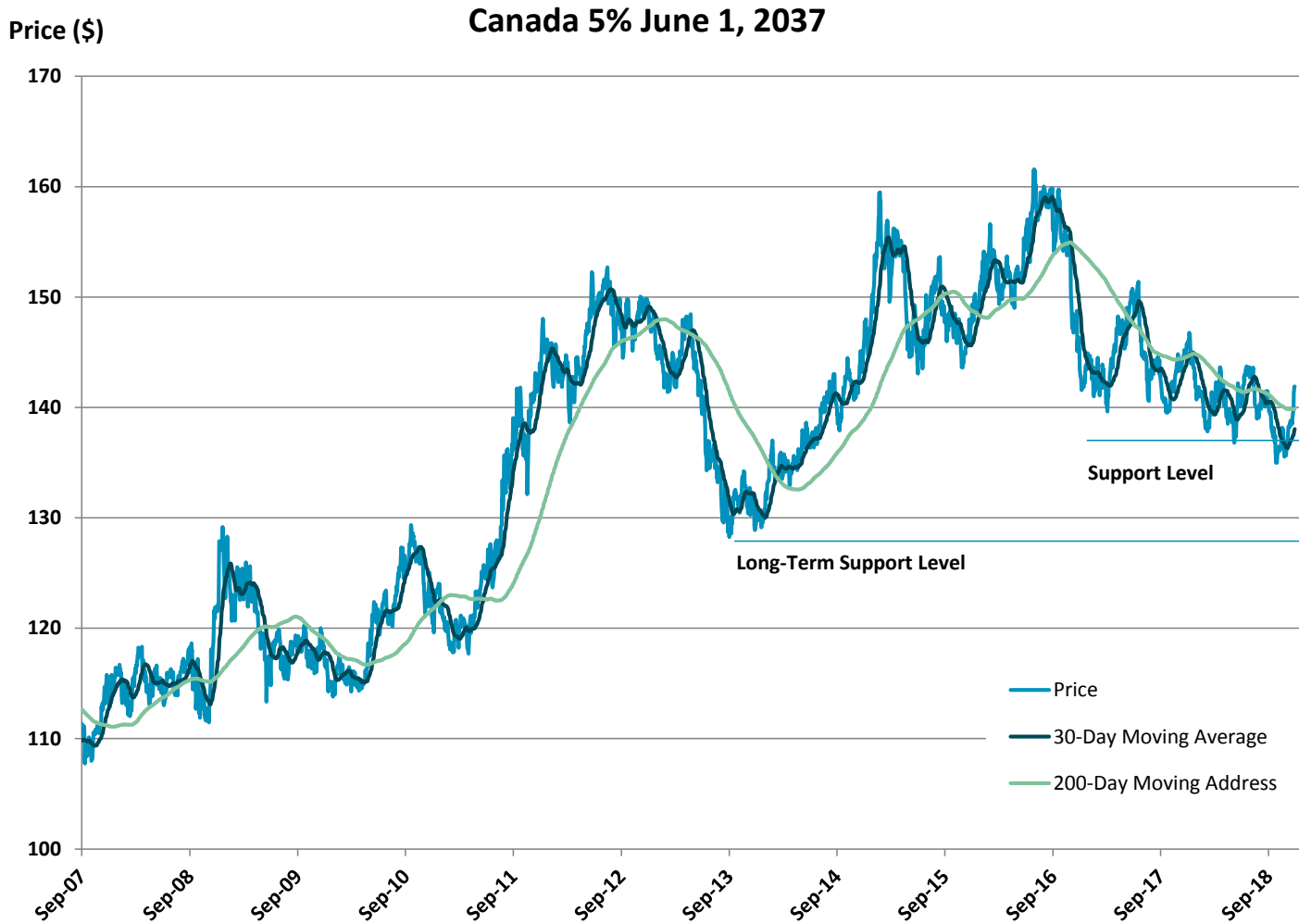
Globally, growth estimates have been pared slightly. The ECB is still expected to end its QE program.

# U.S. 10-Year Treasury

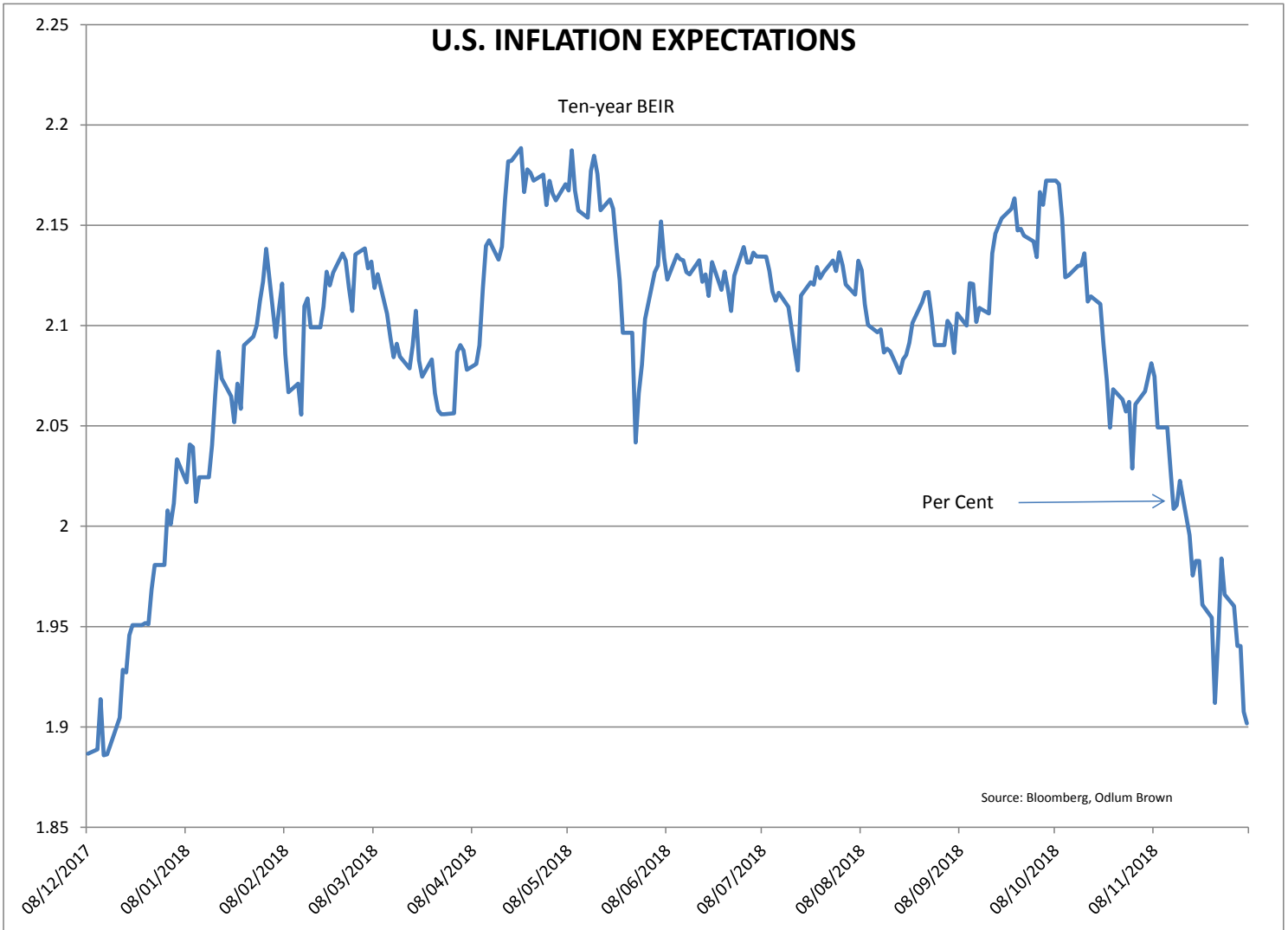


Source: Bloomberg, Odium Brown

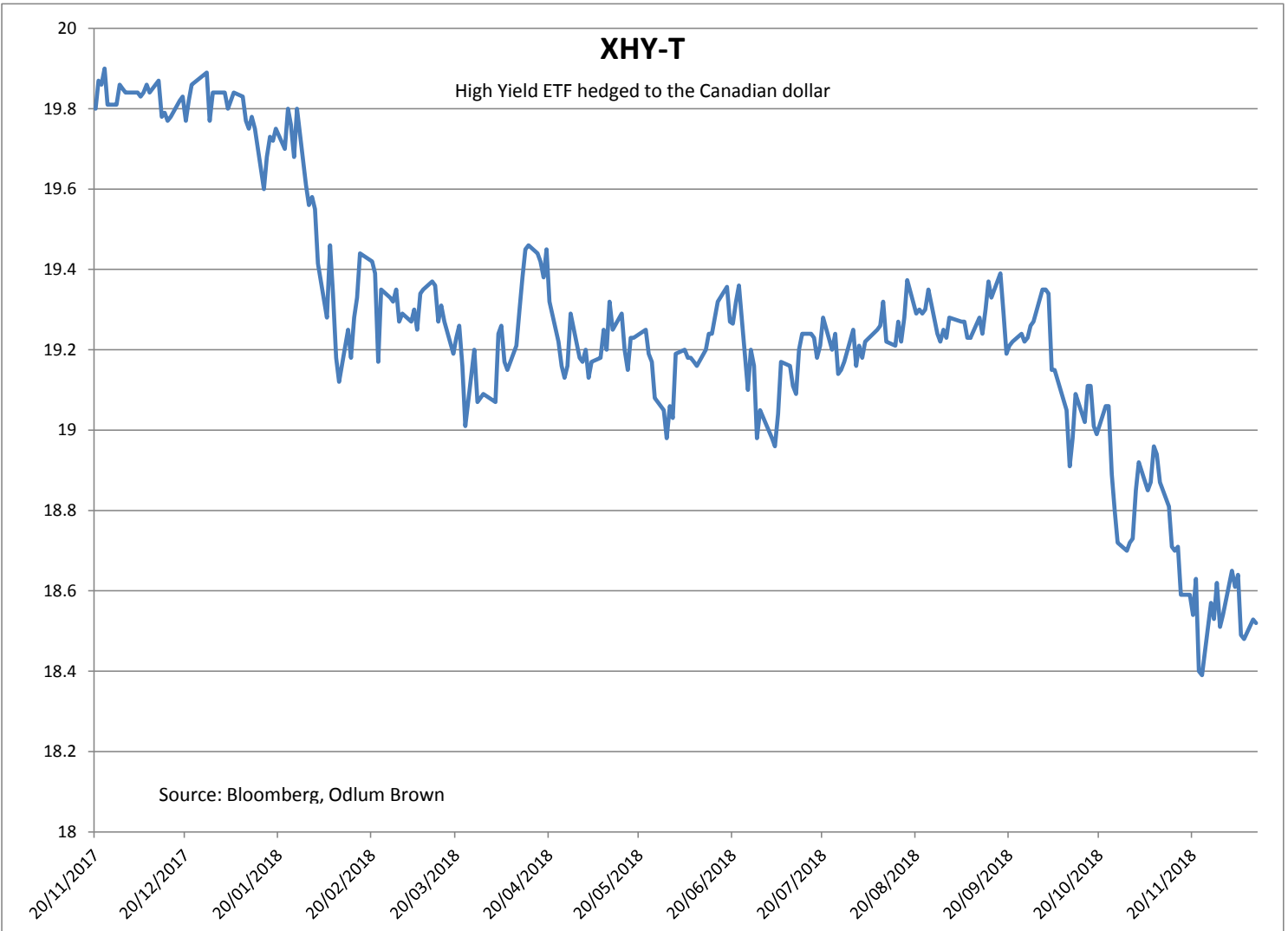
The yield on this bellwether bond reached a double-top at 3.24% and has fallen below the important 200-day moving average.



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.

---

Please read our Odlum Brown Limited Disclaimer and Disclosure - It is important!

Odlum Brown Limited is an independent, full-service investment firm focused on providing professional investment advice and objective research. We respect your right to be informed of relationships with the issuers or strategies referred to in this report which might reasonably be expected to indicate potential conflicts of interest with respect to the securities or any investment strategies discussed or recommended in this report. We do not act as a market maker in any securities and do not provide investment banking or advisory services to, or hold positions in, the issuers covered by our research. Analysts and their associates may, from time to time, hold securities of issuers discussed or recommended in this report because they personally have the conviction to follow their own research, but we have implemented internal policies that impose restrictions on when and how an Analyst may buy or sell securities they cover and any such interest will be disclosed in our report in accordance with regulatory policy. Our Analysts receive no direct compensation based on revenue from investment banking services. We describe our research policies in greater detail, including a description of our rating system and how we disseminate our research, on the Odlum Brown Limited website.

This report has been prepared by Odlum Brown Limited and is intended only for persons resident and located in all the provinces and territories of Canada, where Odlum Brown Limited's services and products may lawfully be offered for sale, and therein only to clients of Odlum Brown Limited. This report is not intended for distribution to, or use by, any person or entity in any jurisdiction or country including the United States, where such distribution or use would be contrary to law or regulation or which would subject Odlum Brown Limited to any registration requirement within such jurisdiction or country. As no regard has been made as to the specific investment objectives, financial situation, and other particular circumstances of any person who may receive this report, clients should seek the advice of a registered investment advisor and other professional advisors, as applicable, regarding the appropriateness of investing in any securities or any investment strategies discussed or recommended in this report.

This report is for information purposes only and is neither a solicitation for the purchase of securities nor an offer of securities. The information contained in this report has been compiled from sources we believe to be reliable, however, we make no guarantee, representation or warranty, expressed or implied, as to such information's accuracy or completeness. All opinions and estimates contained in this report, whether or not our own, are based on assumptions we believe to be reasonable as of the date of the report and are subject to change without notice.

Please note that, as at the date of this report, the Research Analyst responsible for the recommendations herein, associates of such Analyst and/or other individuals directly involved in the preparation of this report hold securities of the issuer(s) referred to directly or through derivatives.

No part of this publication may be reproduced without the express written consent of Odlum Brown Limited. Odlum Brown Limited is a Member of the Canadian Investor Protection Fund.

---