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INVESTMENT RESEARCH

MONTHLY FIXED INCOME UPDATE

Hank Cunningham

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Interest Rate Summary	Jan-31-19	Dec-31-18	29-Dec-17	30-Dec-16	31-Dec-15	31-Dec-14	31-Dec-13
U.S.							
3-Month T-Bill	2.39%	2.36%	1.38%	0.50%	0.16%	0.04%	0.07%
2-Year Treasury	2.45%	2.49%	1.89%	1.19%	1.31%	0.47%	0.38%
10-Year Treasury	2.63%	2.69%	2.41%	2.44%	2.27%	2.17%	3.03%
Canada							
3-Month T-Bill	1.65%	1.64%	1.05%	0.45%	0.51%	0.90%	0.92%
2-Year Canada	1.77%	1.86%	1.69%	0.74%	0.48%	0.99%	1.14%
10-Year Canada	1.88%	1.97%	2.04%	1.72%	1.39%	1.86%	2.76%

Performance

	January 2019	2018	2017	2016	2015	2014	2013
DEX Universe Bond Index	1.34%	1.41%	2.52%	3.52%	3.52%	8.79%	-1.19%
DEX Federal Bond Index	0.90%	2.39%	0.13%	3.66%	3.66%	6.91%	-1.52%
DEX Provincial Bond Index	1.74%	0.66%	4.33%	4.14%	4.14%	12.18%	-2.70%
DEX All Corporate Index	1.68%	1.10%	3.38%	2.71%	2.71%	7.58%	0.84%
DEX "A" Corporate Index	1.89%	0.51%	4. 42%	2.62%	2.62%	9.10%	-0.16%
DEX Real Return Bonds	1.34%	-0.05%	0.72%	2.79%	2.79%	13.18%	-13.1%
DEX High Yield Bonds	1.03%	2.15%	5.20%	13.79%	-5.58%	2.64%	6.87%

Corporate bonds rebounded in January, partly reversing the significant widening in yields from government bonds that occurred in the last quarter of 2018.

Comments

The trend to lower bond yields continued in early 2019 with the bellwether U.S. ten-year note sliding to 2.55%, versus 3.24% in early November. This trend partly reversed over the course of the month, with the ten-year yield closing January at 2.63%, down six basis points.

The conditions favouring these lower yields remained in place, namely: anchored inflation expectations (the five-year outlook is for 2% inflation), and slowing growth, particularly in foreign economies.

However, the U.S. economy is proving to be resilient with solid growth in employment (2.4 million new jobs in 2018) and decent wage growth (3.2% year-over-year). While global growth estimates have been pared, 3% growth is still possible.

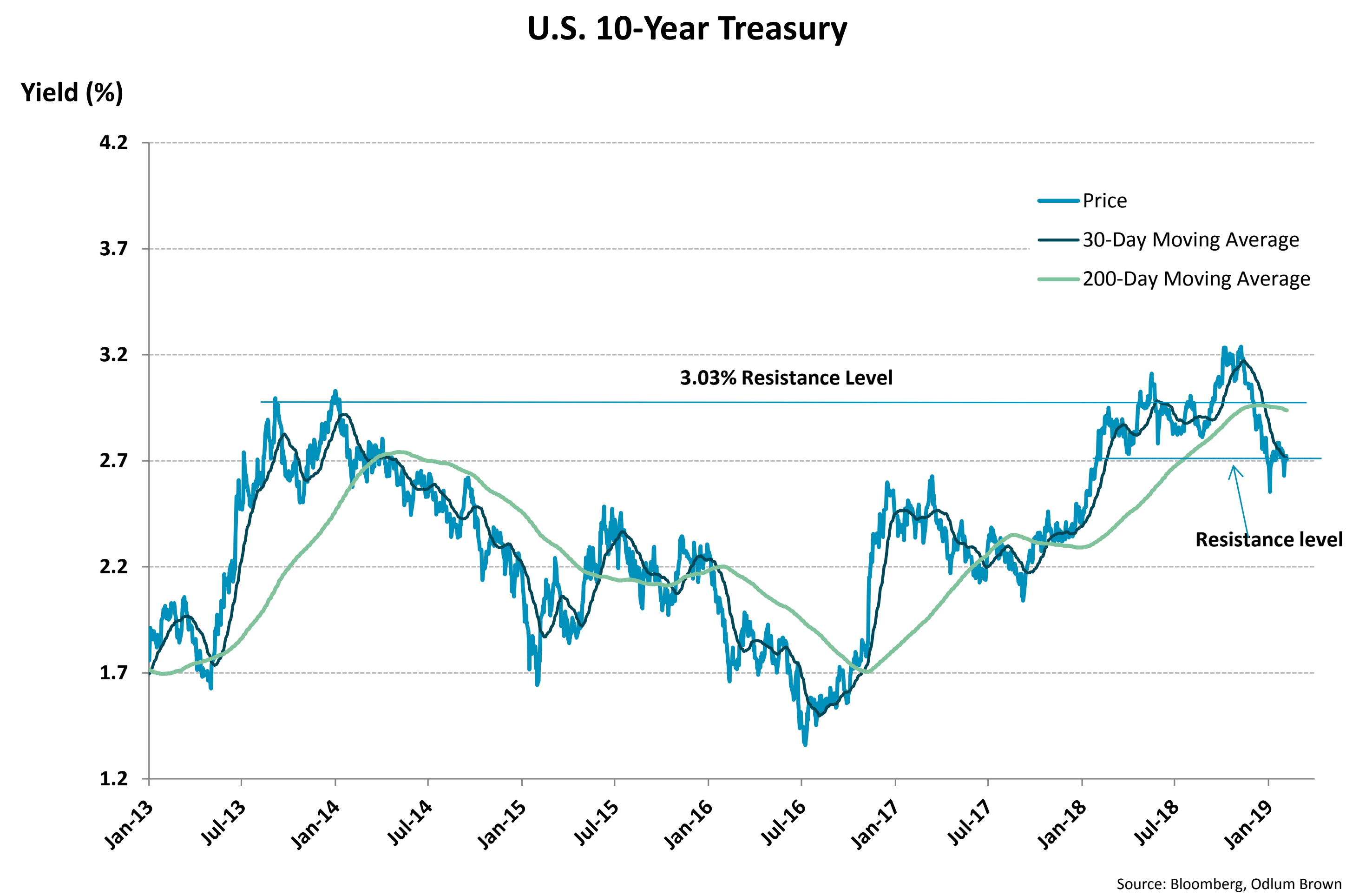
Corporate bonds rebounded from their late-year swoon, with investment grade spreads narrowing by 15 basis points, still 27 basis points wider than they were in November.

Globally, PMIs weakened in Europe with German growth falling to 1% and Italy entering recession. China recorded its weakest GDP since 1990.

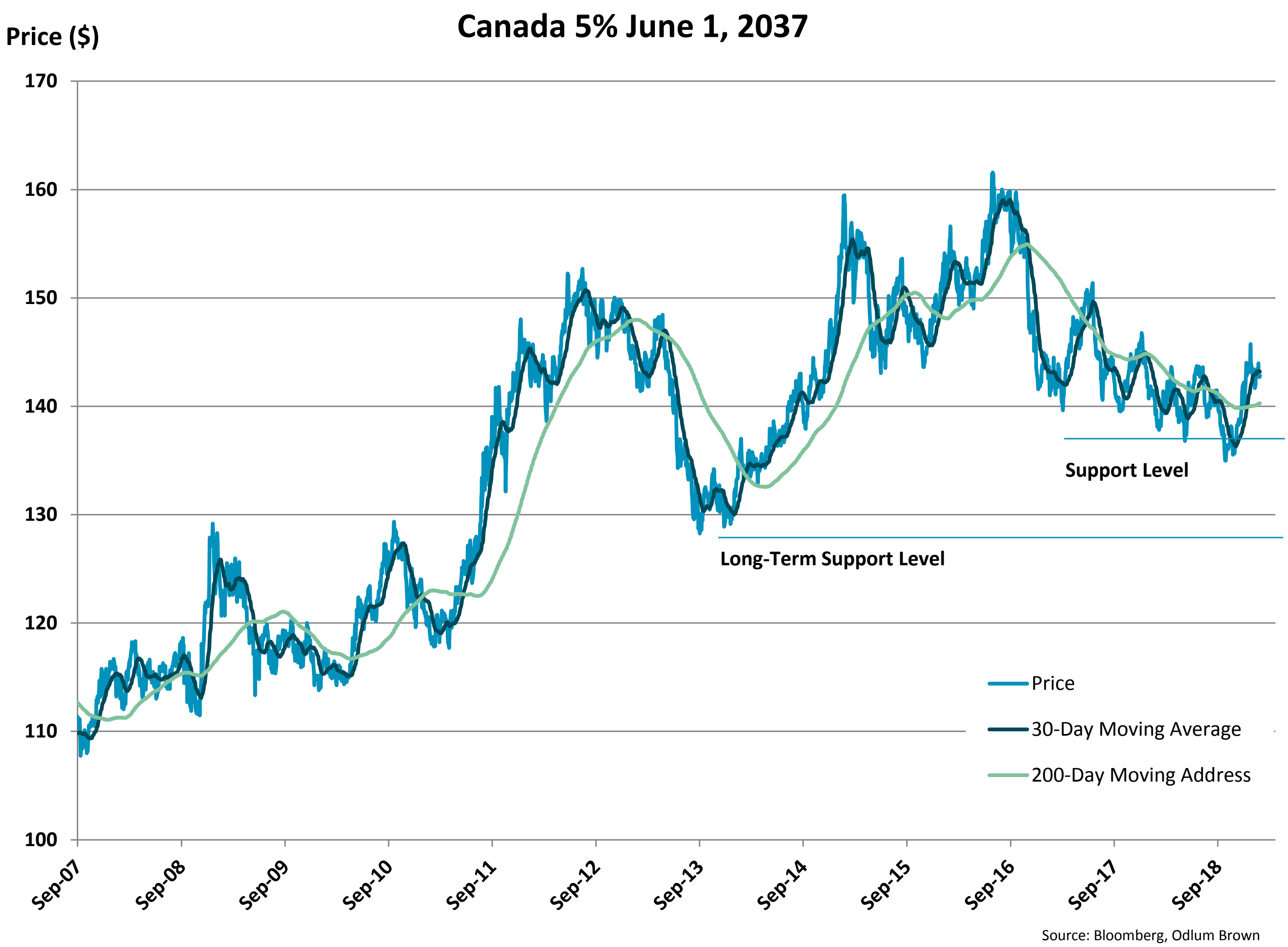
As for Canada, growth weakened in Q4 and estimates for this year have been trimmed by 0.4%. The housing market has softened, partly as a result of tighter lending rules and higher mortgage costs. Consumer confidence remains weak. Nevertheless, the Canadian dollar was one of the strongest currencies in January, rising some 4% versus the U.S. currency. The steady rebound in energy prices was a significant factor.

The Federal Reserve, on February 2, signalled a pause in monetary tightening and flexibility with respect to the timing of its balance sheet management. While many observers opine that this means no Fed Funds hike this year, it is by no means a certainty. The U.S. economy remains resilient in important sectors such as employment, capital investment, and consumer confidence and spending.

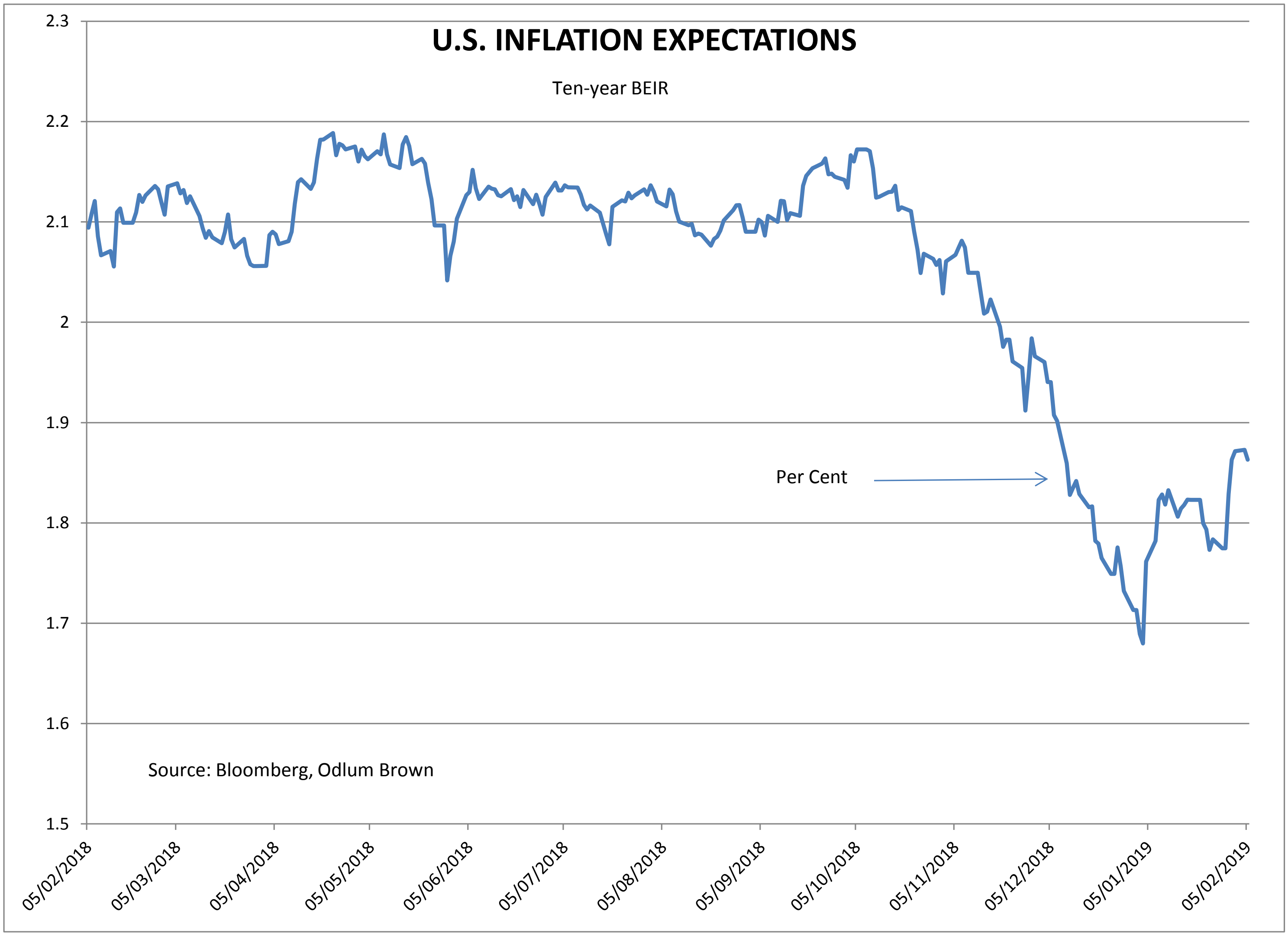
The Fed's actions have placed the Bank of Canada squarely on the sidelines. Ten-year yields in Canada remain below the inflation rate and the Canadian dollar, even after the January rally, remains competitive.



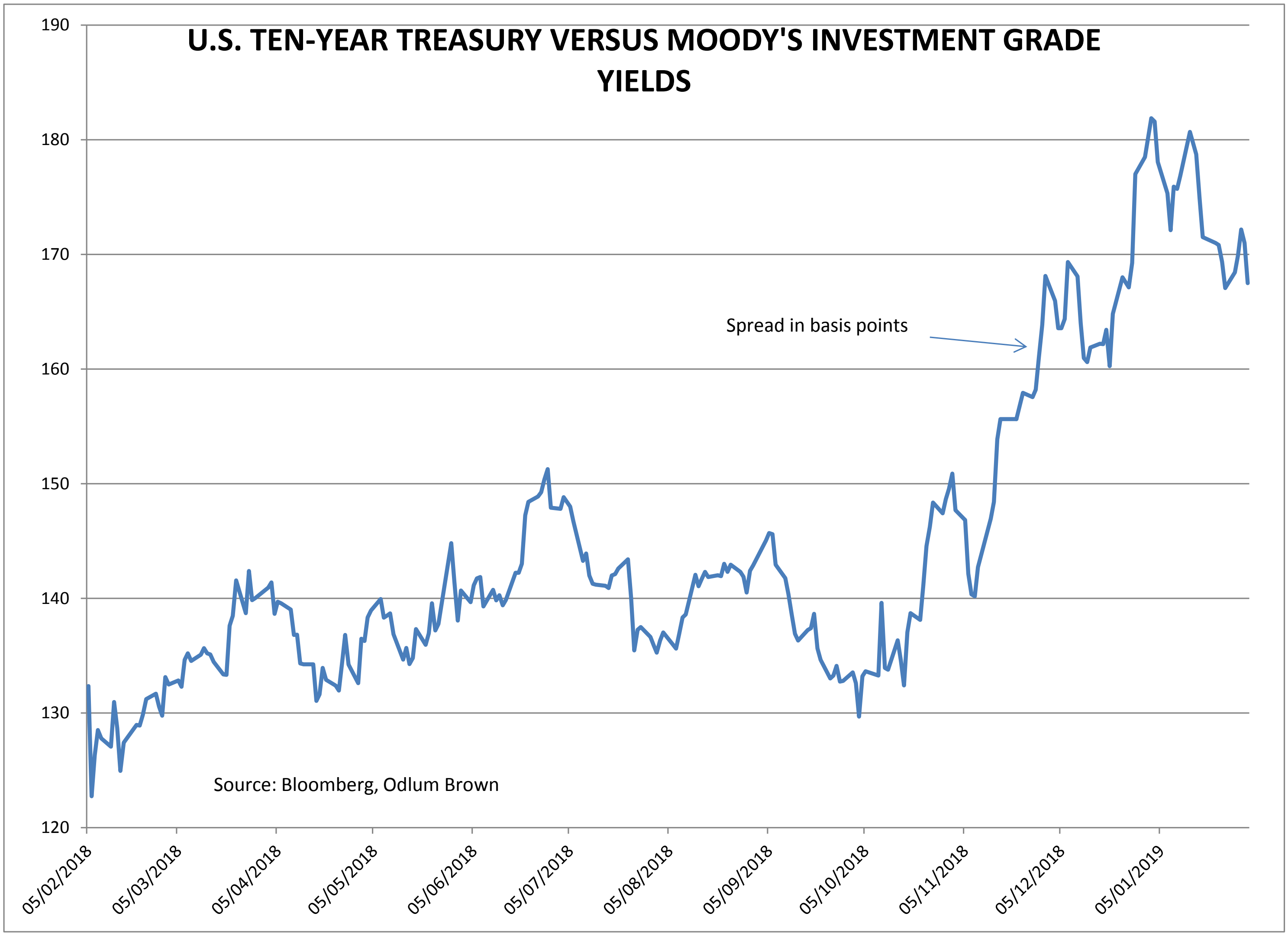
This bellwether bond peaked at 3.24% in November, and after touching 2.55%, it moved up to the ten-day moving average of 2.70%.



The price of this long-term Canada bond rebounded from its support levels and moved above its 200-day moving average, but is below the 30-day moving average with falling momentum.



Inflation expectations rebounded but remain below 2%.



The yield spread between investment grade bonds and Treasury bonds narrowed during January.

Outlook

With the dramatic shift away from tightening by the Federal Reserve, the bond market will react to natural forces. Yields are locked in a narrow trading range with the ten-year anchored close to 2.70%. The two-year note slipped to 2.50%, thus contributing to a modest steepening in the yield curve. Conditions in the corporate bond market, both investment grade and high yield, have improved to a more normal state, with a steady flow of primary issues accompanied by narrowing spreads.

The bond market appears to be in a state of equilibrium, as inflation ebbs and growth slows. The ten-year yield should trade in a range of 2.50% to 3.00%. Close attention should be paid to inflation but any serious uptick seems unlikely.

The U.S. faces an avalanche of new Treasury issuance to fund its swollen deficit and it will continue to reduce its balance sheet, but on a flexible basis.

At the margin, the U.S. dollar could soften and with improvement in energy pricing and in other key commodities, the Canadian dollar could benefit further.

Fixed income investors can therefore look forward to another year of modest returns, in the 2% to 4% range.

Strategy

We continue to stress investment in high-quality, short-duration corporate bonds. We favour the one-to-five year laddered approach. As for the high-yield market, conditions have improved and investors may consider investing 5% to 10% of their fixed income portfolios in this sector, preferably through ETFs. Also, investors may consider using one of our selected outside fixed income managers.

For further discussion, please speak to your investment advisor.