Monthly Fixed Income Update

Hank Cunningham **January 8, 2019**

Interest Rate Summary	Dec-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	2.36%	1.38%	0.50%	0.16%	0.04%	0.07%	0.04%
2-Year Treasury	2.49%	1.89%	1.19%	1.31%	0.47%	0.38%	0.25%
10-Year Treasury	2.69%	2.41%	2.44%	2.27%	2.17%	3.03%	1.76%
Canada							
3-Month T-Bill	1.64%	1.05%	0.45%	0.51%	0.90%	0.92%	0.92%
2-Year Canada	1.86%	1.69%	0.74%	0.48%	0.99%	1.14%	1.14%
10-Year Canada	1.97%	2.04%	1.72%	1.39%	1.86%	2.76%	1.80%

Performance

	2018	2017	2016	2015	2014	2013	2012
DEX Universe Bond Index	1.41%	2.52%	3.52%	3.52%	8.79%	-1.19%	2.65%
DEX Federal Bond Index	2.39%	0.13%	3.66%	3.66%	6.91%	-1.52%	2.11%
DEX Provincial Bond Index	0.66%	4.33%	4.14%	4.14%	12.18%	-2.70%	
DEX All Corporate Index	1.10%	3.38%	2.71%	2.71%	7.58%	0.84%	6.22%
DEX “A” Corporate Index	0.51%	4. 42%	2.62%	2.62%	9.10%	-0.16%	6.85%
DEX Real Return Bonds	-0.05%	0.72%	2.79%	2.79%	13.18%	-13.1%	
DEX High Yield Bonds	2.15%	5.20%	13.79%	-5.58%	2.64%	6.87%	

Government bonds outperformed corporate bonds for the year as yield spreads widened significantly, particularly in the last two months of the year. Real Return bonds produced mildly negative returns for the year, while high yield bonds remained positive at 2.15%.

Comments

On November 8, 2018, 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 closed the year at 2.49% and 2.69%. What happened?

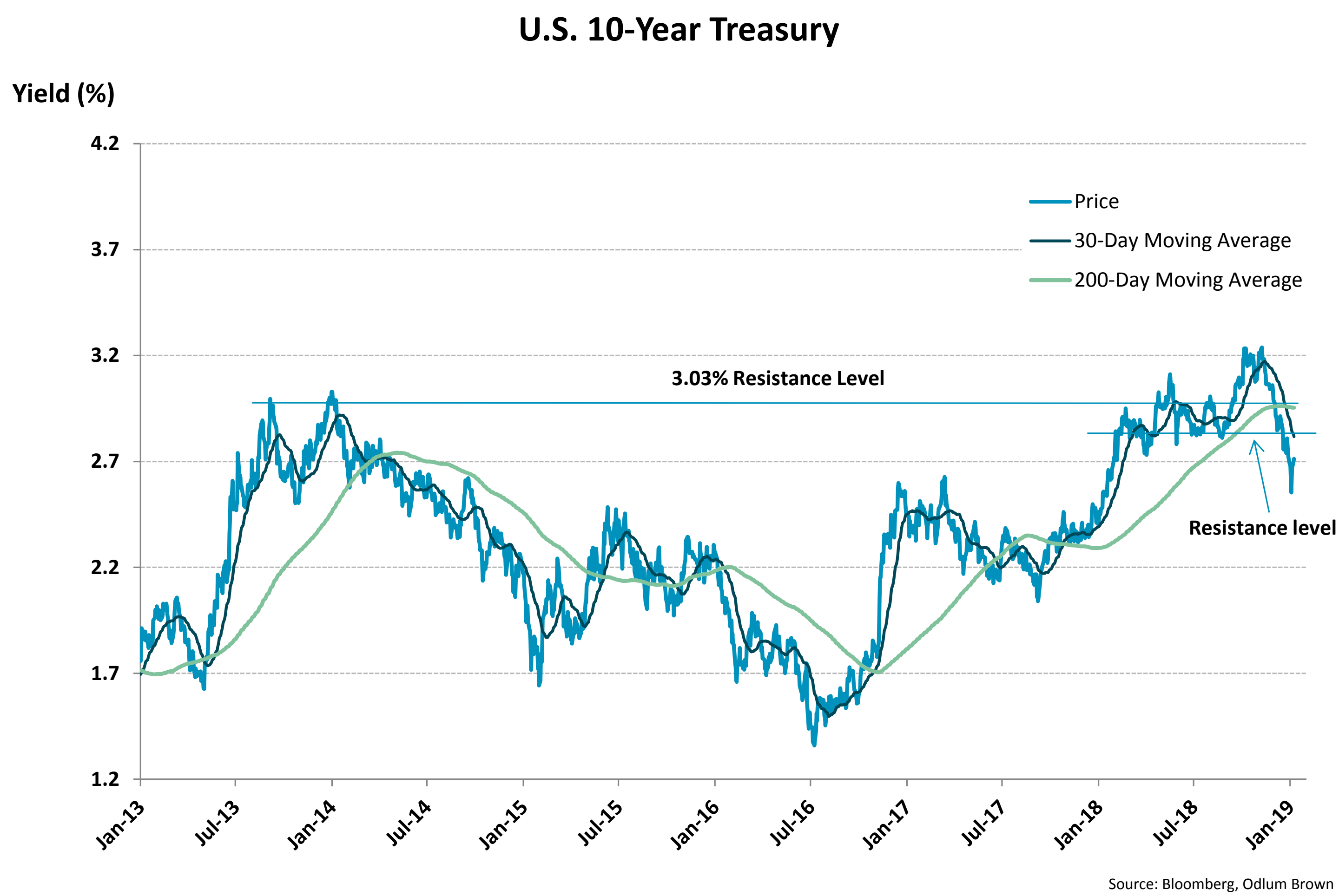
A number of factors contributed to this startling turnaround:

1. Slowing global growth, most notably in the Euro area, Japan and China. Purchasing managers’ indices were weaker.
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 little upward pressure on wages.
5. Growing concern over trade issues.

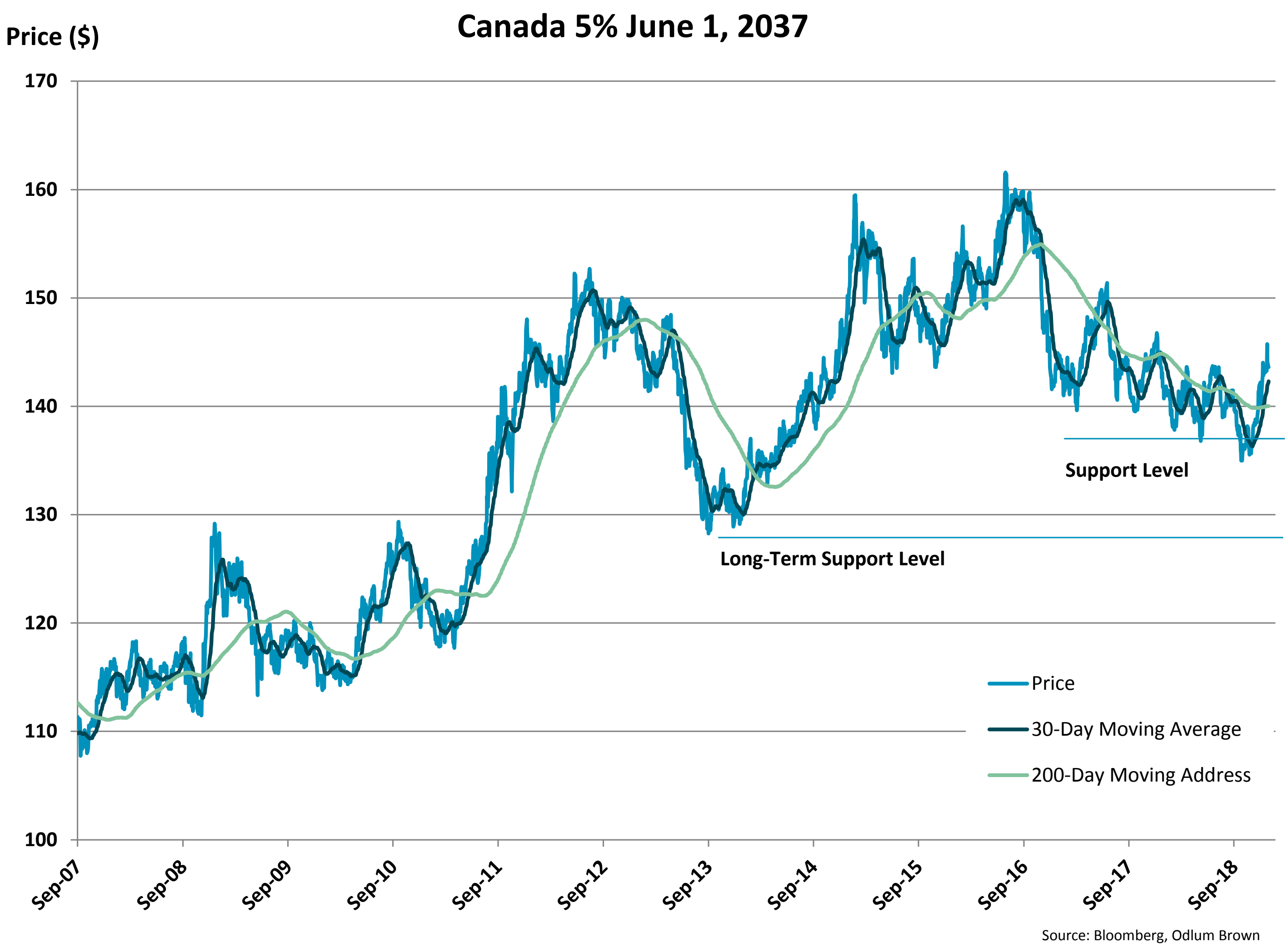
6. Credit market worries about potential downgrades. The corporate bond market suffered and underperformed the Treasury market. New issue financing became difficult with price concessions necessary.
7. Weakness in equity markets.
8. Downgrades in GDP growth estimates. The U.S growth rate is expected to fall below a 3% pace, while Canada's growth rate should fall below 2%.

In Canada, following its most recent rate hike on October 24, 2018 and accompanying positive outlook, the Bank of Canada left its key lending rate unchanged on December 5, 2018 and downgraded its outlook significantly. The Canadian dollar, already struggling with the effect of weak commodity prices, sagged further.

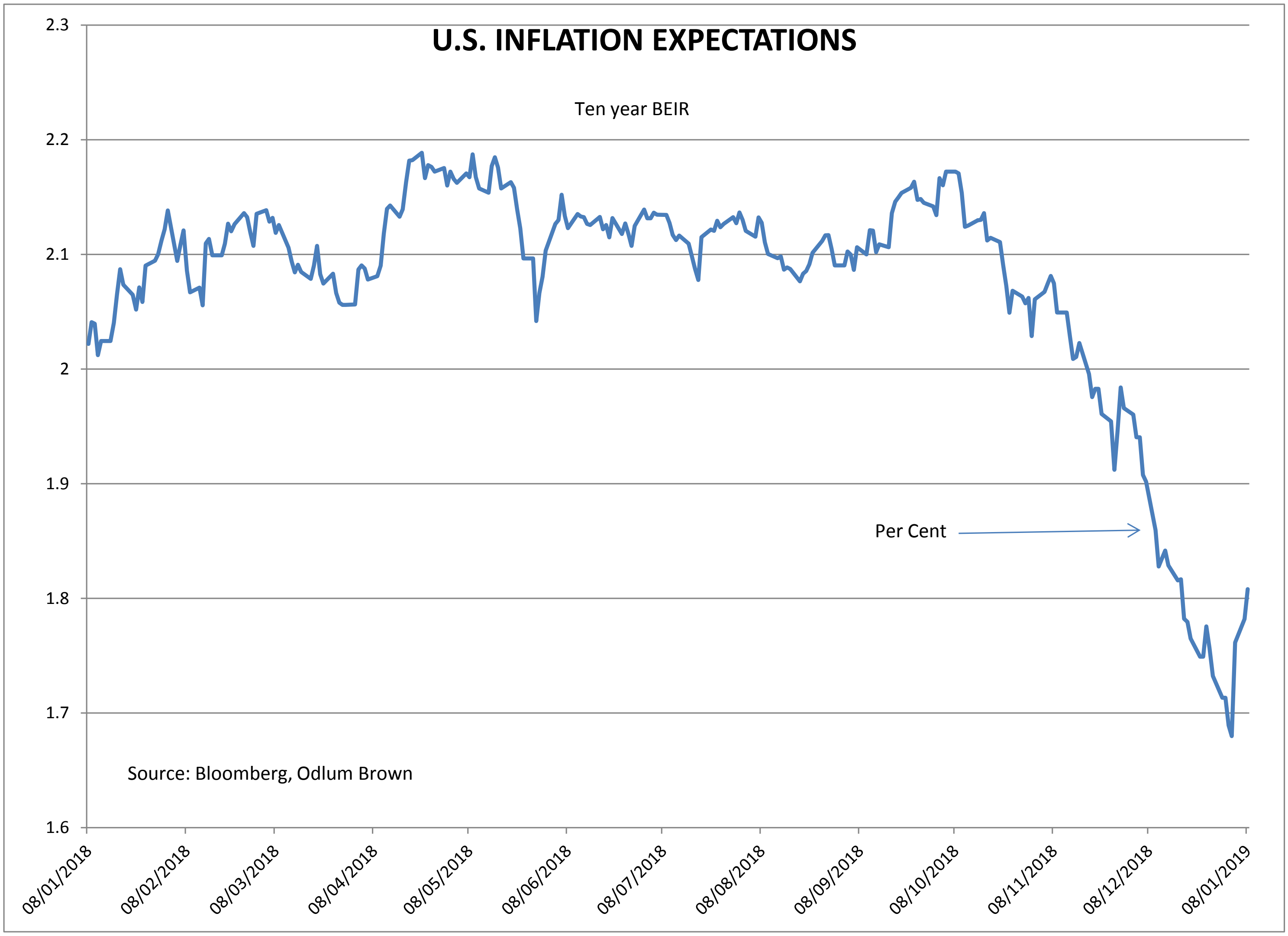
Globally, growth estimates have been pared slightly. The European Central Bank has ended its quantitative easing program.



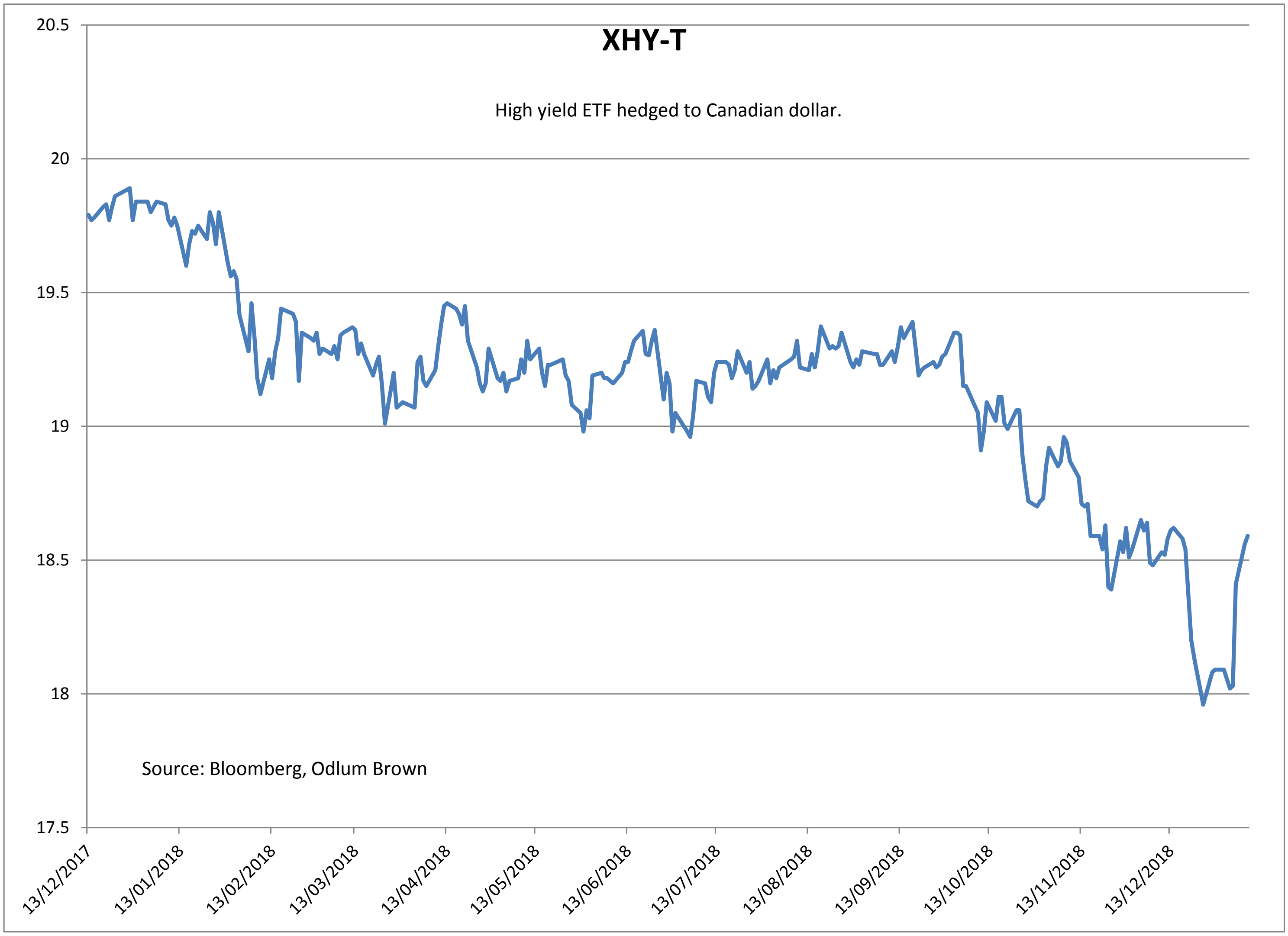
This bellwether bond peaked at 3.24% in November and has trended lower, moving well below its key moving averages.



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



Inflation expectations have rebounded but remain below 2%.



The high yield market rebounded from the late 2018 selloff.

Outlook

Evidence continues to accumulate that economic growth is slowing, both globally and in North America. Rising interest rates have had a negative impact on housing and vehicle markets, and manufacturing has crested with weak global PMIs and the U.S. ISM having its worst downturn in ten years.

Occurring against a backdrop of moderate, stable inflation, this slowdown is affecting the Federal Reserve and the Bank of Canada. Recently, the Federal Reserve signalled a more flexible approach to monetary policy; the futures market is forecasting low chances of Fed Funds increases this year.

Despite concerns in the credit markets towards the end of the year, the corporate bond market remains in decent shape but requires close scrutiny for possible over-leveraging and potential downgrades.

Bearish pressures remain, however, for bond prices. Inflation could rear its head, especially if the current rally in commodity prices continues. The combination of the ongoing monthly reduction in the Fed's balance sheet plus a tsunami of new issuance of Treasury securities to fund the swollen U.S. Federal budget deficit should affect bond yields at the margin.

Changes in bond yields are nevertheless expected to be subdued and contained. With a more dovish approach by the Fed and bond yields at the low end of the forecasted range, the yield curve could steepen slightly. The current rally in energy prices and in commodities broadly, could push inflation modestly higher and push the ten-year yield back to the 3.00% - 3.25% area.

U.S. employment remains buoyant, supporting consumer confidence and spending, and this should be sufficient to avert a recession this year. The U.S. produced 2.6 million jobs last year and there remain 7 million unfilled jobs.

U.S. GDP growth should moderate below 3% while Canada's should move below 2%.

Global growth should remain weak, but modestly positive. There are wild cards, particularly in the trade sector, but it is difficult to attribute anything to this important area.

With this moderate outlook, the U.S. dollar should weaken and in turn, could extend the current rally in commodities, assisting the Canadian dollar to advance.

Therefore, we expect U.S. two-year yields to remain close to 2.5% while the ten-year should fluctuate between 2.60% and 3.24%. Canadian yields will remain subdued; the yield curve should be relatively flat with yields close to 2% at all maturities. Mortgage rates, therefore, may decline somewhat. It will thus be another year of modest returns for fixed income investors.

STRATEGY

Given the above forecast, we favour our ongoing approach of investing in top-quality corporate bonds with an average duration of three years. The widening of corporate bond yields in the fourth quarter of 2018 provides investors with the opportunity of receiving enhanced returns. We counsel vigilance towards credit quality.

Floating rate notes should be avoided as the Bank of Canada will not likely raise rates anytime soon.

The high yield market also had a challenging fourth quarter. Investors could consider investing 5% to 10% of a fixed income portfolio in the high yield space either by investing in ETFs or by electing to use one of our selected and approved outside fixed income managers.

For further discussion, please speak to your investment advisor.