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INVESTMENT RESEARCH

Monthly Fixed Income Update

Hank Cunningham | **July 13, 2020**

Interest Rate Summary	Jun-30-20	Dec-31-19	Dec-31-18	29-Dec-17	30-Dec-16	31-Dec-15
U.S.						
3-Month T-Bill	0.14%	1.55%	2.36%	1.38%	0.50%	0.16%
2-Year Treasury	0.15%	1.57%	2.49%	1.89%	1.19%	1.31%
10-Year Treasury	0.66%	1.92%	2.69%	2.41%	2.44%	2.27%
Canada						
3-Month T-Bill	0.20%	1.65%	1.64%	1.05%	0.45%	0.51%
2-Year Canada	0.29%	1.69%	1.86%	1.69%	0.74%	0.48%
10-Year Canada	0.51%	1.70%	1.97%	2.04%	1.72%	1.39%

Performance

	YTD	2019	2018	2017	2016	2015	2014
DEX Universe Bond Index	7.53%	6.87%	1.41%	2.52%	3.52%	3.52%	8.79%
DEX Federal Bond Index	7.52%	3.73%	2.39%	0.13%	3.66%	3.66%	6.91%
DEX Provincial Bond Index	9.06%	9.07%	0.66%	4.33%	4.14%	4.14%	12.18%
DEX All Corporate Index	5.41%	8.05%	1.10%	3.38%	2.71%	2.71%	7.58%
DEX “A” Corporate Index	6.03%	9.65%	0.51%	4.42%	2.62%	2.62%	9.10%
DEX Real Return Bonds	6.28%	8.02%	-0.05%	0.72%	2.79%	2.79%	13.18%
DEX High Yield Bonds	-2.08%	8.48%	2.15%	5.20%	13.79%	-5.58%	2.64%

All sectors produced positive performance in June. Corporate bonds, both investment grade and high yield, outperformed governments for the third consecutive month. The backstopping of the corporate bond market by the Federal Reserve and the Bank of Canada has restored confidence and has led to a record number of new issues.

Comments:

	Jun-30-20	May-29-20	Apr-30-20	Mar-31-20	Feb-28-20	Jan-31-20
U.S. 3-month T Bills	0.14%	0.14%	0.10%	0.09%	1.28%	1.55%
U.S. 2-year bonds	0.15%	0.16%	0.20%	0.25%	0.92%	1.32%
U.S. 10-year bonds	0.66%	0.65%	0.61%	0.67%	1.15%	1.51%

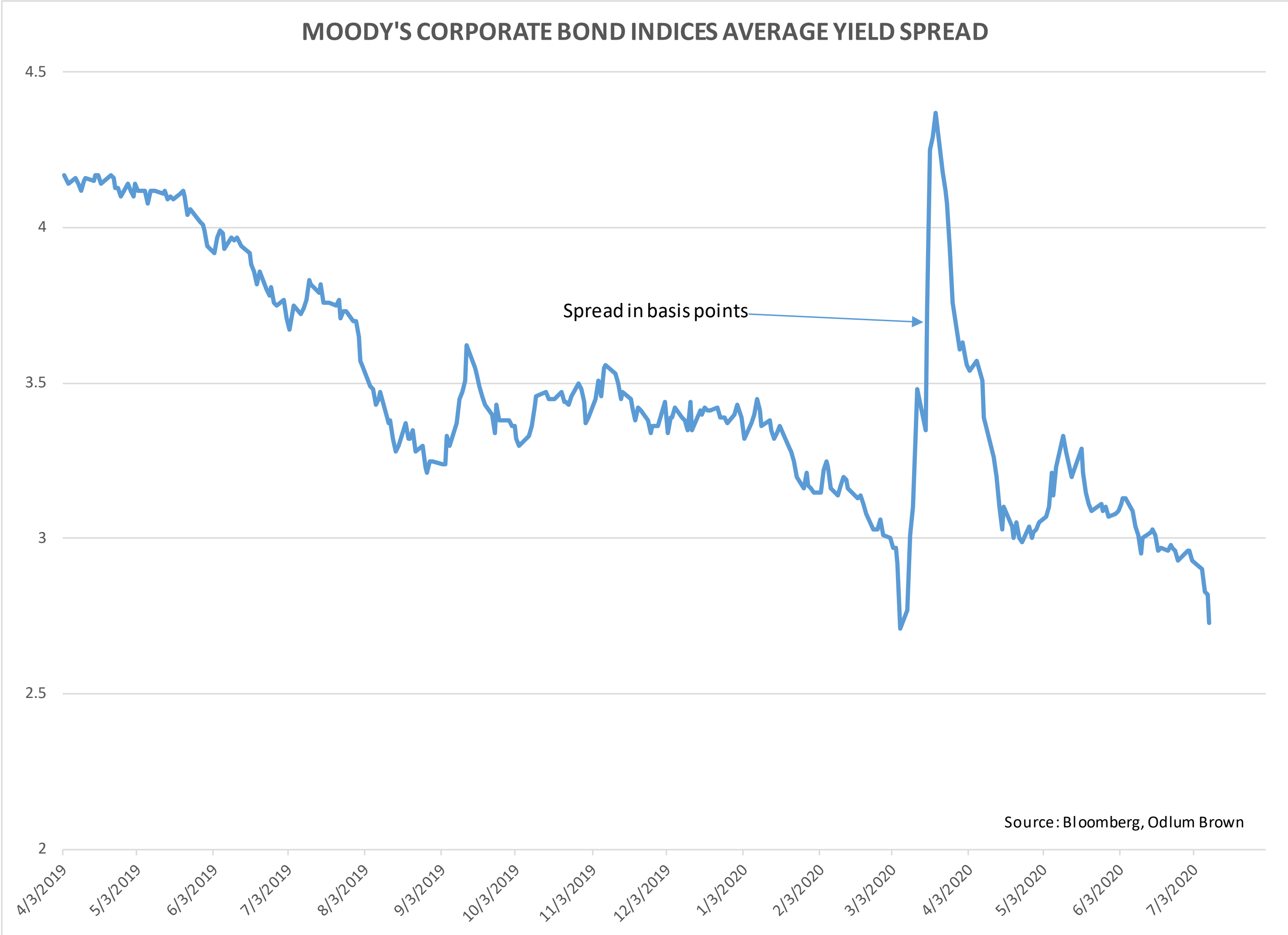
For the third consecutive month, there was little net change in government bond yields. However, credit markets continued to revive, with both investment grade and high yield corporate bond spreads narrowing steadily. After two months of record issuance, bond financing eased. Of late, the high yield market has weakened, but it is still attracting positive net investment.

Capping two months of a somewhat erratic, uneven restarting of the U.S. and Canadian economies, there was more good news on the employment front. The U.S. added 4.8 million jobs, pushing the unemployment rate down to 11.1%, while Canada added almost 1 million new jobs. Thus, recovering approximately one-third of job losses.

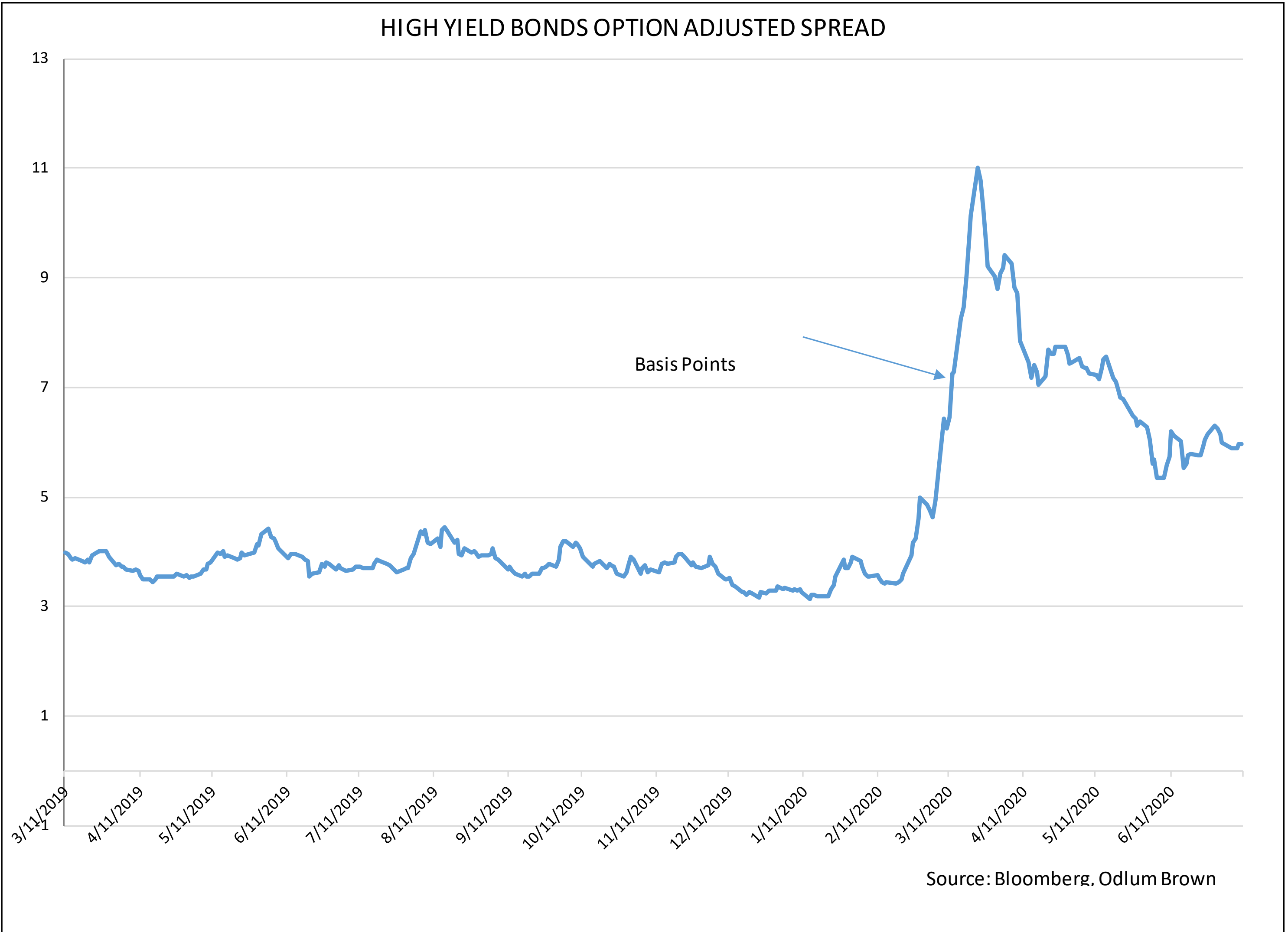
There has been noticeable improvement in ISM numbers, as well as housing, vehicle sales and, importantly, consumer confidence. Consumer balance sheets are in good shape.

There is no sign of a pickup in inflation but there has been strength in oil, gold and copper.

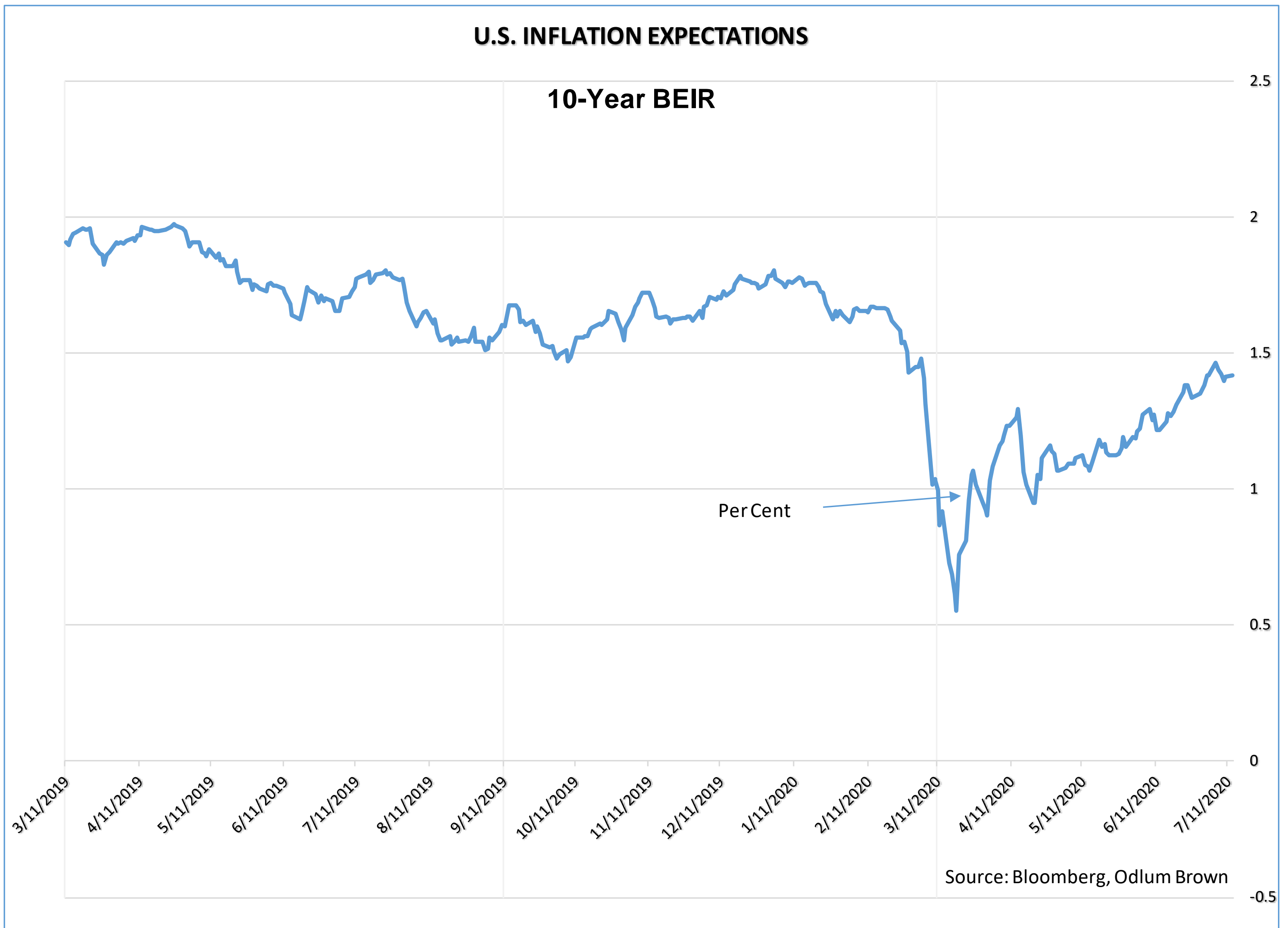
This global bellwether issue continues to trade near historic low yields.



Investment grade corporate bonds have retraced almost all of their earlier widening.



The high-yield market has stabilized after recent improvement.



Inflation expectations have improved but remain well below 2%.

Outlook

There is ample evidence that an economic recovery of some sort is taking place. After two straight months of strength in the employment sectors in the U.S. and Canada, approximately one-third of the job losses have been regained.

With yields on U.S. Treasury bonds anchored at current levels, investors continue to invest in corporate bonds, particularly investment grade. Of late, high yield bonds have stalled as concerns over default rates rise.

We believe that Government bonds are overpriced as the Fed and the Bank of Canada are pulling out all the stops to keep bond yields low. This flies in the face of burgeoning budget deficits and the attendant increase of government bond issuance.

The Federal Reserve, thus far, has eschewed formal yield curve control. Both the U.S. and Canadian monetary authorities have indicated a desire to issue dramatically more long-term bonds. Ultimately, this should add upward pressure on long-term yields.

There is scant evidence of any uptick in inflation; rather, reported inflation is trending lower, even negative in some cases. However, gold prices, energy, copper and inflation-protected bonds have all caught a strong bid.

Overall, we judge government bond yields to be vulnerable to:

1. **Strengthening economy**
2. **Inflation trend**
3. **Bond supply**

GDP forecasts point to global growth of -4% in 2020, with the U.S. and Canada forecast to grow at -6% and -6.8% respectively, rebounding in 2021 by plus 4.7% and 5.5% respectively.

For the near term, we expect no upward moves in bond yields. The recovery should be erratic and produce little to no inflation pressure. Bond yields will remain anchored near recent low levels, influenced heavily by the Federal Reserve and the Bank of Canada.

Strategy

We continue to stress the importance of including high-quality fixed income securities in client portfolios. In this environment, we favour non-cyclical corporate bonds, such as those issued by utilities, banks, telecommunications and recurring-revenue businesses.

Conditions have improved in the secondary bond market and there has been significant retracement of the widening in corporate bond yield spreads, both investment grade and high yield. Primary issuance of investment grade corporate bonds and high yield bonds reached record levels in May but eased in June.

We have long recommended the laddered approach to fixed income investing. We continue to do so and, in addition to high-quality corporate credits, investors may wish to consider short-term provincial bonds.

Eventually, we will turn our attention to inflation-protected bonds. It is premature to do so given the likelihood of benign inflation for the next couple of years.

For several years, we have had an approved list of outside fund managers. At present, in order to augment returns and benefit from their expertise in credit markets, we recommend two of these managers in particular, who are well positioned for this market environment. For further discussion, please speak to your Portfolio Manager or Investment Advisor.

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