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INVESTMENT RESEARCH

MONTHLY FIXED INCOME UPDATE

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October 10, 2018

Interest Rate Summary	28-Sep-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	2.20%	1.38%	0.50%	0.16%	0.04%	0.07%	0.04%
2-Year Treasury	2.82%	1.89%	1.19%	1.31%	0.47%	0.38%	0.25%
10-Year Treasury	3.06%	2.41%	2.44%	2.27%	2.17%	3.03%	1.76%
Canada							
3-Month T-Bill	1.58%	1.05%	0.45%	0.51%	0.90%	0.92%	0.92%
2-Year Canada	2.21%	1.69%	0.74%	0.48%	0.99%	1.14%	1.14%
10-Year Canada	2.43%	2.04%	1.72%	1.39%	1.86%	2.76%	1.80%

Performance

	Sep-2018	2017	2016	2015	2014	2013	2012
DEX Universe Bond Index	-0.97%	2.52%	3.52%	3.52%	8.79%	-1.19%	2.65%
DEX Federal Bond Index	-0.83%	0.13%	3.66%	3.66%	6.91%	-1.52%	2.11%
DEX Provincial Bond Index	-1.25%	4.33%	4.14%	4.14%	12.18%	-2.70%	
DEX All Corporate Index	-0.79%	3.38%	2.71%	2.71%	7.58%	0.84%	6.22%
DEX "A" Corporate Index	-1.24%	4. 42%	2.62%	2.62%	9.10%	-0.16%	6.85%
DEX Real Return Bonds	1.47%	0.72%	2.79%	2.79%	13.18%	-13.1%	
DEX High Yield Bonds	0.23%	5.20%	13.79%	-5.58%	2.64%	6.87%	

All sectors produced negative returns in September with the exception of Real Return and High Yield Bonds.

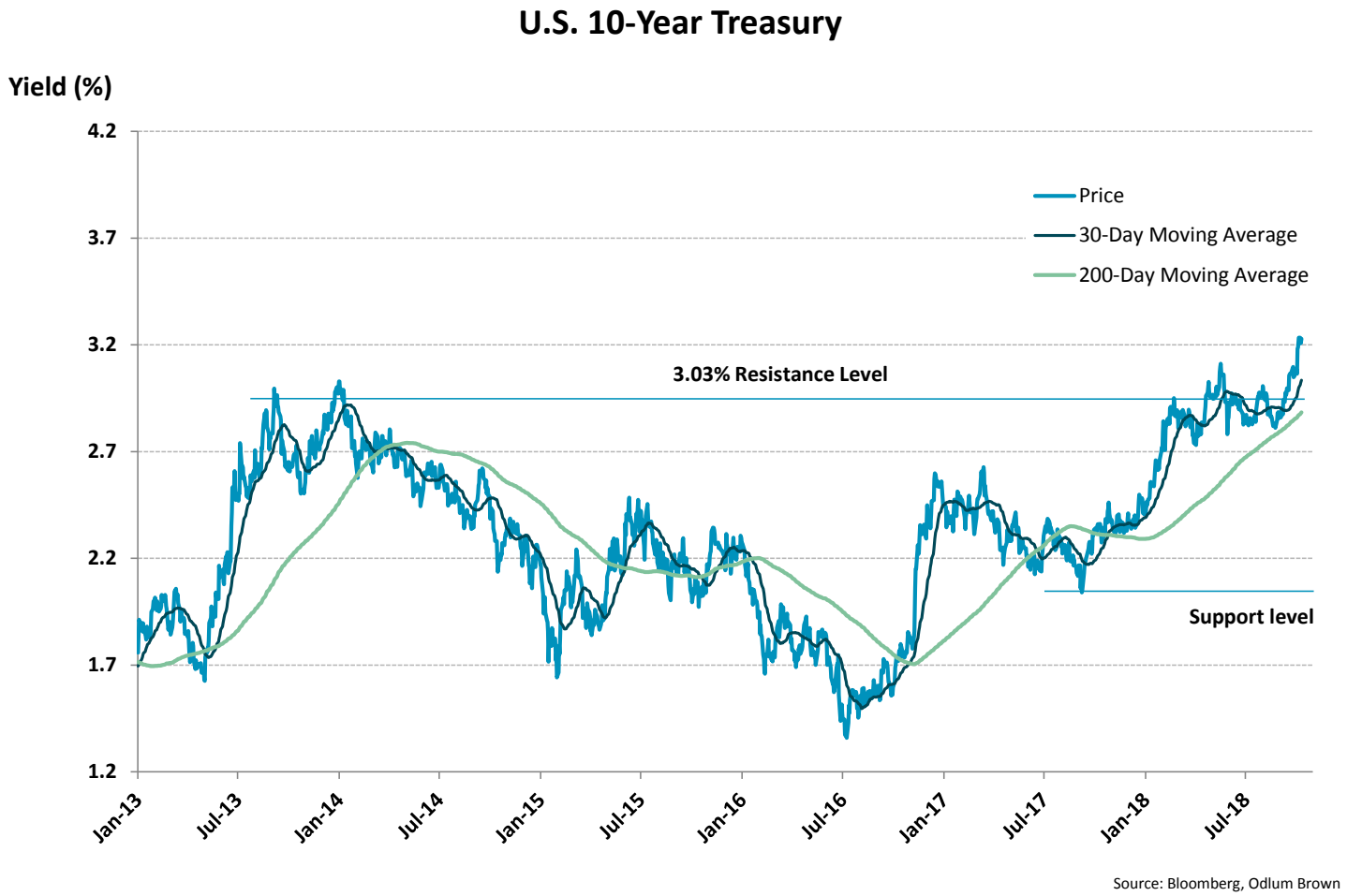
Comments

September brought higher yields at all maturities with the bellwether U.S. ten-year tacking on 20 basis points to reach 3.06%. The employment report at the beginning of the month was generally strong with average hourly earnings reaching a nine-year high of 2.9%. The Federal Reserve followed this with another increase of 25 basis points, citing the strong economy and leaving little doubt that there would be another such increase in December.

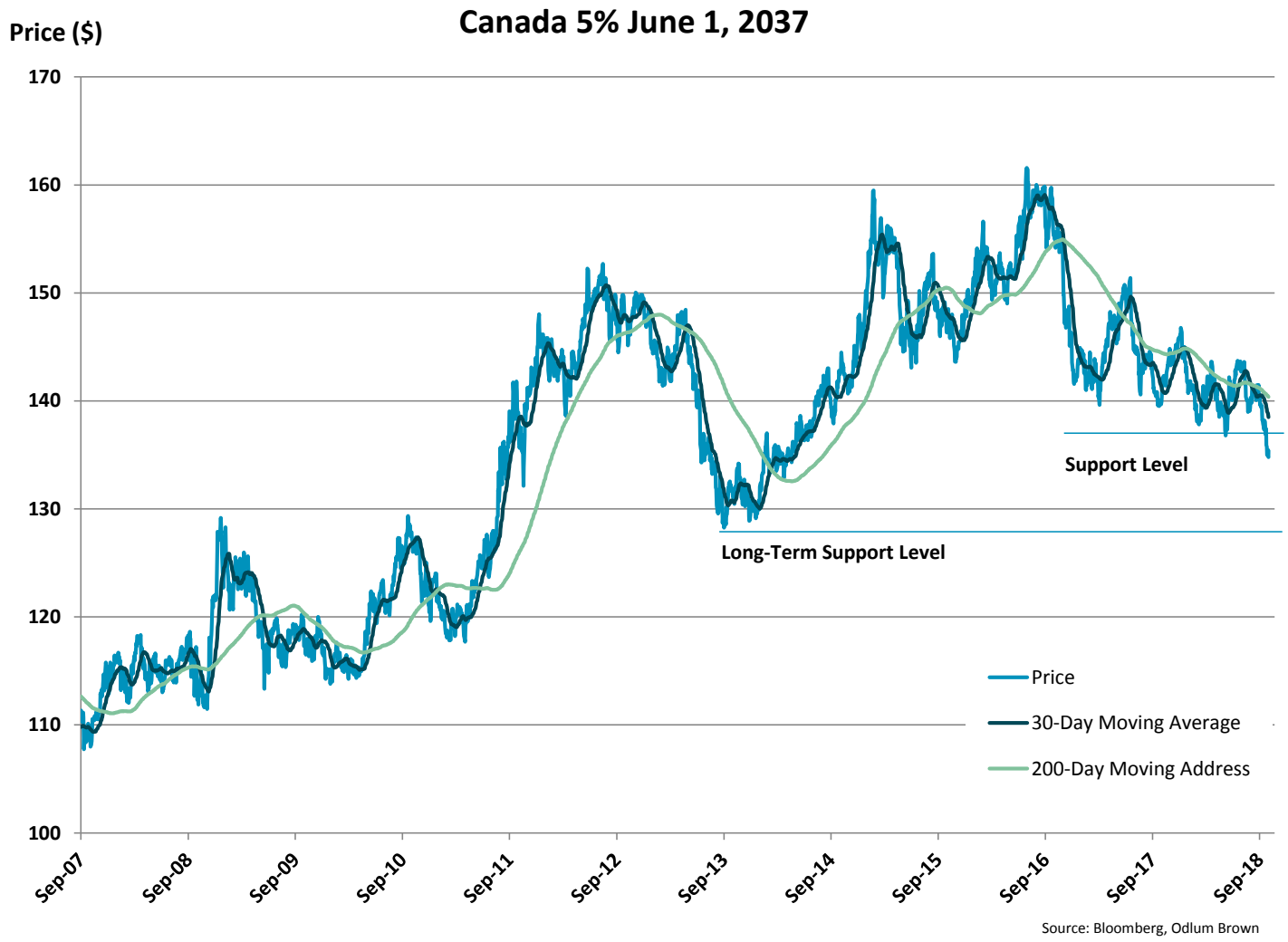
The Bank of Canada was in a cautious mode, mostly as a result of the uncertainty surrounding trade talks. It did foresee gradual interest rate hikes over time, but dismissed the 3% inflation numbers as transitory. Now that the Fed has indicated that it will continue to remove monetary accommodation and following the trade agreement, the Bank of Canada will raise its key lending rate later this month.

Globally, bond yields inched higher. The ECB's press conference was a yawner but, more importantly, its QE program was cut in half as of October 1.

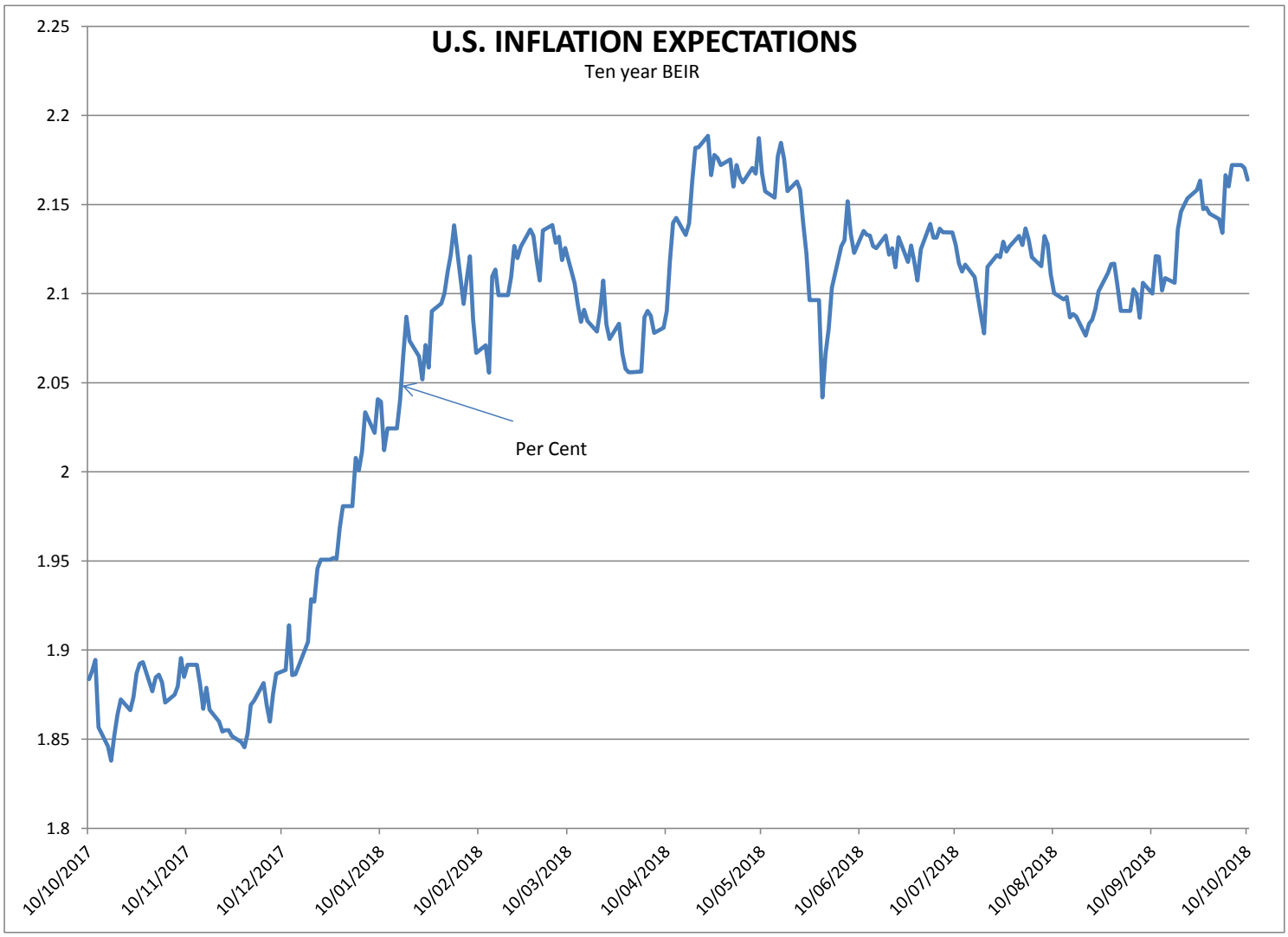
The bond market tanked in early October, with the U.S. ten–year tacking on a fast 20 basis points to reach 3.25%. The genesis for this rout was a robust ISM non-manufacturing report. This was followed by another solid employment report, with the unemployment rate at a 50-year low of 3.9%. During this selloff, the yield curve steepened somewhat.



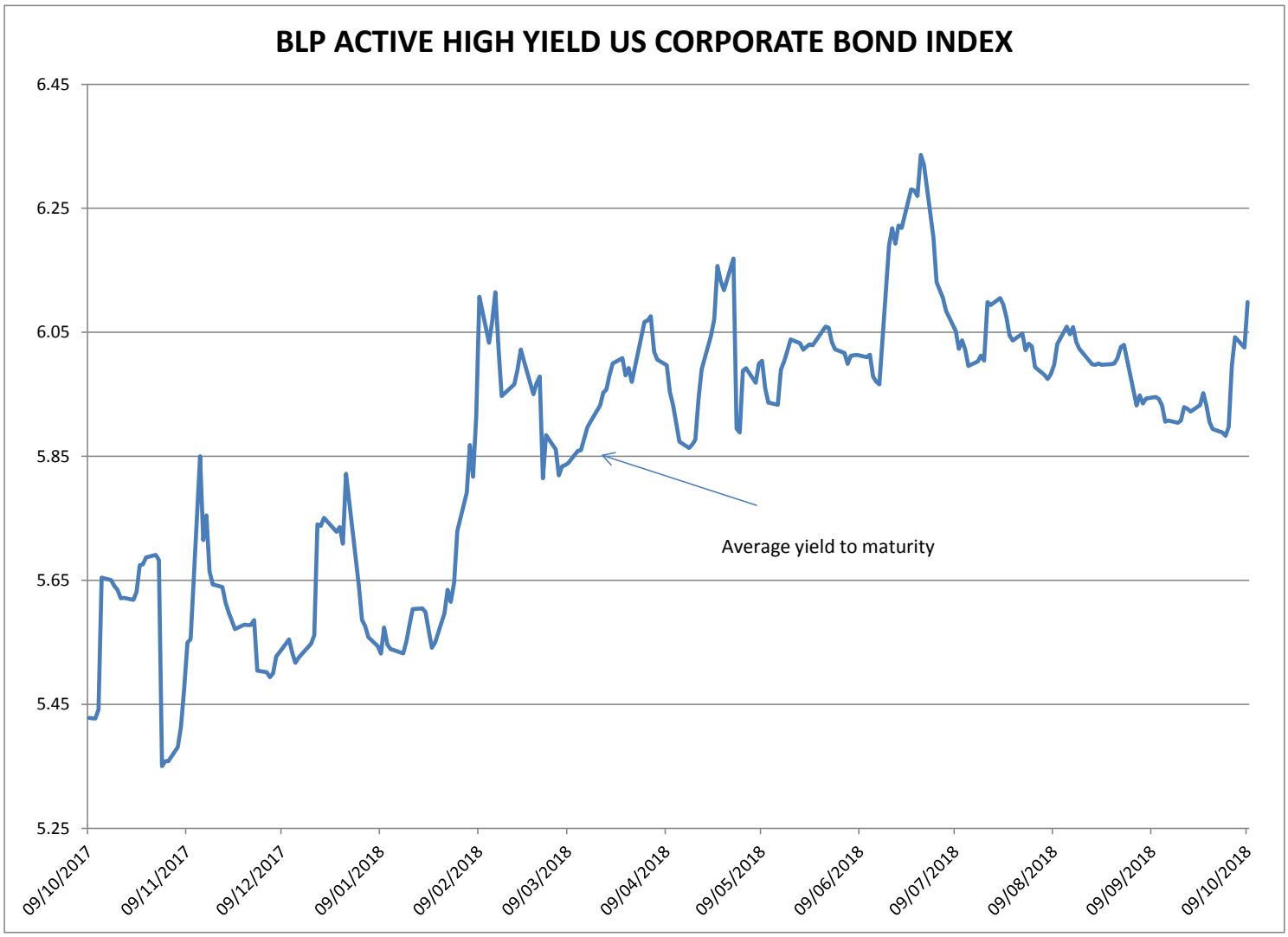
The yield on this bellwether bond has breached an important resistance point.



The price of this long-term Canada bond has broken below a key support level.



Inflation expectations remain solidly above two percent, but show little sign of accelerating.



The high yield market has succumbed to rising Treasury yields and is selling off.

This chart offers the perspective on the last 65 years of bond yields.

Outlook

The U.S. ten-year yield has reached our year-end target of 3.25%. At first glance, the fundamentals favouring higher bond yields, namely strong economic growth, tight labour markets and elevated consumer confidence, to name a few, remain in place.

In the short run, it is likely that bond prices will recover after such a swift fall, perhaps pushing 10 year Treasury yields back close to 3%.

The Federal Reserve will continue to withdraw monetary stimulus as it moves the Fed Funds Rate past a neutral setting and as it continues to run down its balance sheet holdings. Some cracks are showing in the corporate bond market, both investment grade and high yield, and we will see some widening of yield spreads from government bonds.

Longer term, we believe bond yields will continue to grind higher with a target of 3.5% to 4% for the bellwether U.S. ten-year.

Strategy

We continue to recommend maintaining high-quality, short duration portfolios of corporate bonds. As short- and mid-term yields rise, these portfolios will generate additional income as maturities are reinvested while preserving capital at the same time. In this fashion, we expect modest positive returns and increased income.

We still counsel that clients maintain a modest exposure to the high yield market as, with credit conditions generally stable, this will enhance the returns from government and investment-grade corporate bonds.

We also advocate investment in floating rate debentures which will benefit from rising short-term yields, while having a short duration.

We remain in favour of selected investment in funds of certain investment management firms that have been successful at generating positive returns with short duration portfolios.

For more information, please speak to your advisor.