MONTHLY FIXED INCOME UPDATE

Hank Cunningham **September 13, 2020**

Interest Rate Summary	Aug-31-20	Dec-31-19	Dec-31-18	29-Dec-17	30-Dec-16	31-Dec-15
U.S.						
3-Month T-Bill	0.10%	1.55%	2.36%	1.38%	0.50%	0.16%
2-Year Treasury	0.13%	1.57%	2.49%	1.89%	1.19%	1.31%
10-Year Treasury	0.71%	1.92%	2.69%	2.41%	2.44%	2.27%
Canada						
3-Month T-Bill	0.14%	1.65%	1.64%	1.05%	0.45%	0.51%
2-Year Canada	0.27%	1.69%	1.86%	1.69%	0.74%	0.48%
10-Year Canada	0.62%	1.70%	1.97%	2.04%	1.72%	1.39%

Performance

	YTD	2019	2018	2017	2016	2015	2014
DEX Universe Bond Index	7.66%	6.87%	1.41%	2.52%	3.52%	3.52%	8.79%
DEX Federal Bond Index	7.11%	3.73%	2.39%	0.13%	3.66%	3.66%	6.91%
DEX Provincial Bond Index	8.73%	9.07%	0.66%	4.33%	4.14%	4.14%	12.18%
DEX All Corporate Index	6.81%	8.05%	1.10%	3.38%	2.71%	2.71%	7.58%
DEX "A" Corporate Index	7.01%	9.65%	0.51%	4.42%	2.62%	2.62%	9.10%
DEX Real Return Bonds	10.95%	8.02%	-0.05%	0.72%	2.79%	2.79%	13.18%
DEX High Yield Bonds	1.70%	8.48%	2.15%	5.20%	13.79%	-5.58%	2.64%

All sectors produced positive performance in August. Corporate bonds, both investment grade and high yield, outperformed government bonds for the fourth consecutive month. Real return bonds outperformed all other sectors in July.

Comments:

	Aug-31-20	Jul-31-20	Jun-30-20	May-29-20	Apr-30-20	Mar-31-20	Feb-28-20
U.S. 3-month T Bills	0.10%	0.09%	0.14%	0.14%	0.10%	0.09%	1.28%
U.S. 2-year bonds	0.13%	0.11%	0.15%	0.16%	0.20%	0.25%	0.92%
U.S. 10-year bonds	0.71%	0.53%	0.66%	0.65%	0.61%	0.67%	1.15%

Bond yields rose in August, with the U.S. ten-year bellwether yield climbing 25 basis points before closing the month at 0.71%. With two-year yields effectively anchored by the Federal Reserve Board (and by most Central Banks), the yield curve steepened. The extraordinary rate of issuance of new government notes and bonds may have exceeded the rate of quantitative easing buying, producing some sloppy auctions in the process.

Of significant note to the markets was the revised inflation-targeting by the Fed, whereby it will tolerate inflation running above the target until it averages 2%. There is no game plan for bringing this about, nor do analysts know how this might work. Initially, bond yields rose but have settled back down. Also, the Fed continues to talk down the possibility of yield curve control; it would take a sharp jump in bond yields before the Fed would institute this tactic. The mere threat of it may keep longer-term bond yields under control. Inflation has begun to rear its head, as witness the steady climb in producer prices and consumer inflation, strength in key commodity prices and further gains in inflation expectations.

There is evidence that negative real yields may lessen, paving the way for higher nominal yields.

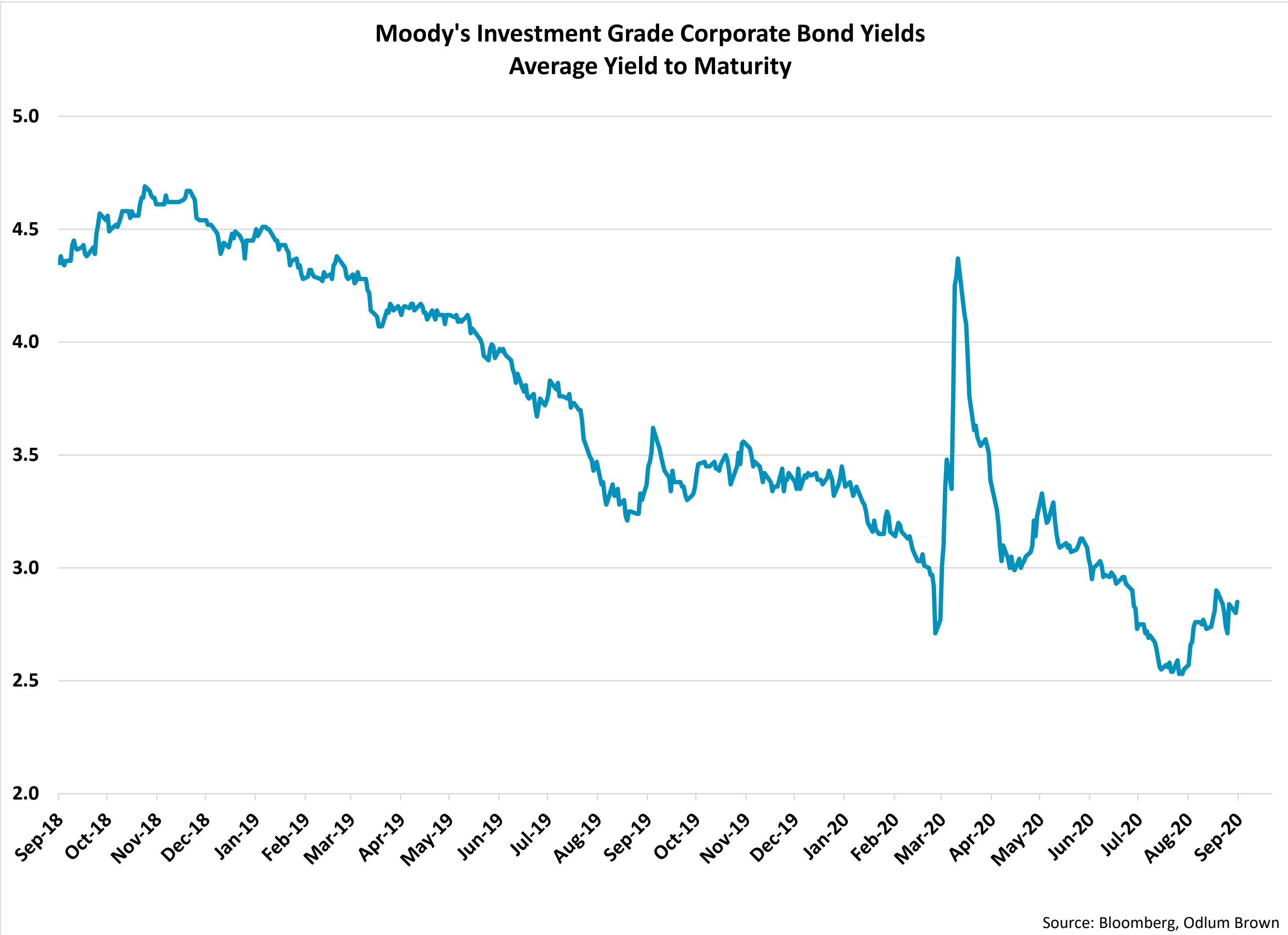
Meanwhile, economic activity has continued to rebound. The employment market, housing market, industrial production and retail sales have all continued to beat estimates. The U.S. labour market has regained an amazing 10.6 million jobs with the unemployment rate falling to 8.4%. Canada has had a similar recovery with 1.9 million jobs added and the unemployment rate falling to 10.2%. Thus, two-thirds of Canada's job losses and one-half of those of the U.S. have returned.

Demand for corporate bonds, both investment grade and high yield, has continued unabated with record issuance and further narrowing of yield spreads to government bonds. Appetite for new issues remains strong.

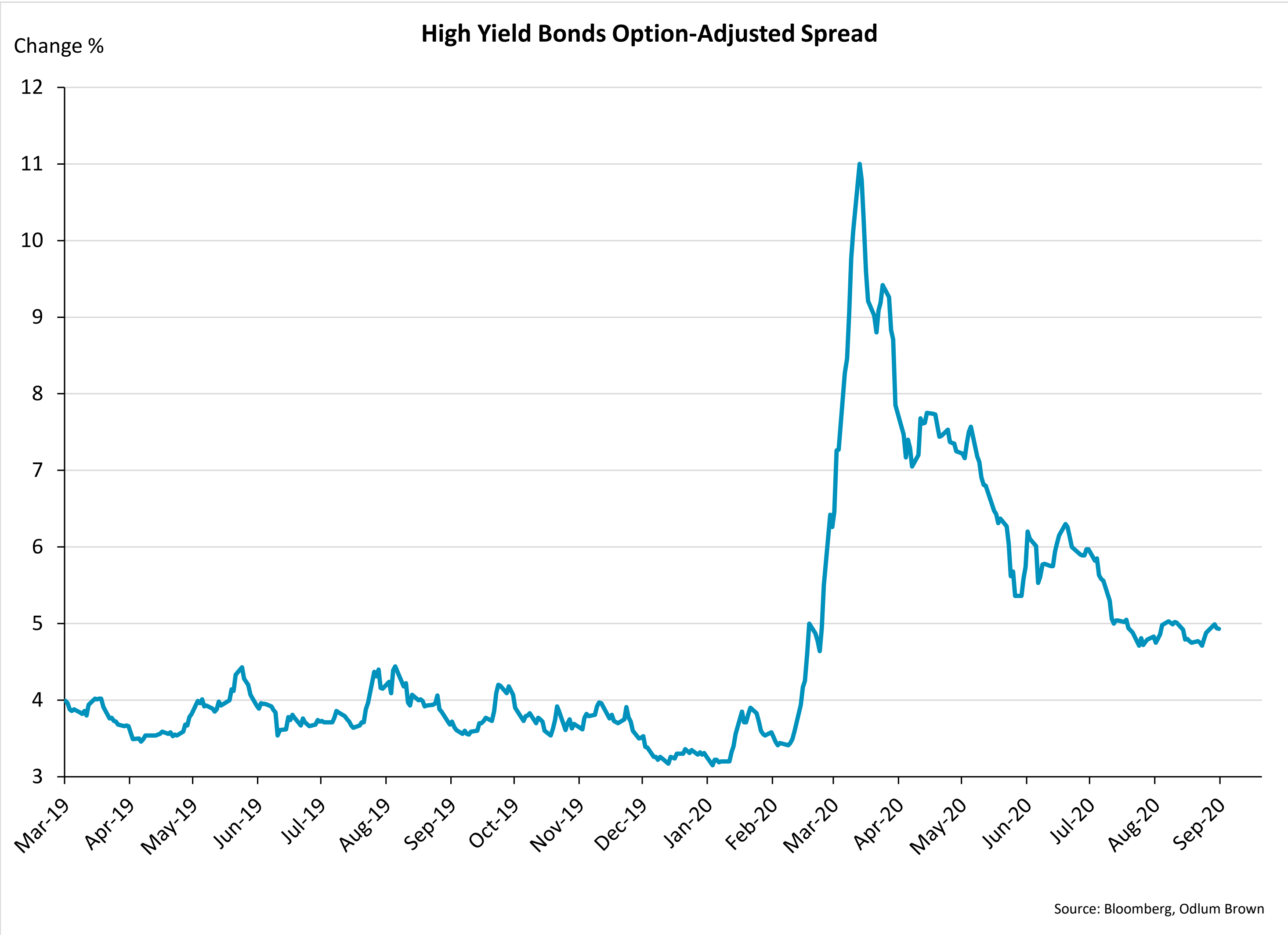
U.S. 10-Year Treasury

Source: Bloomberg, Odlum Brown

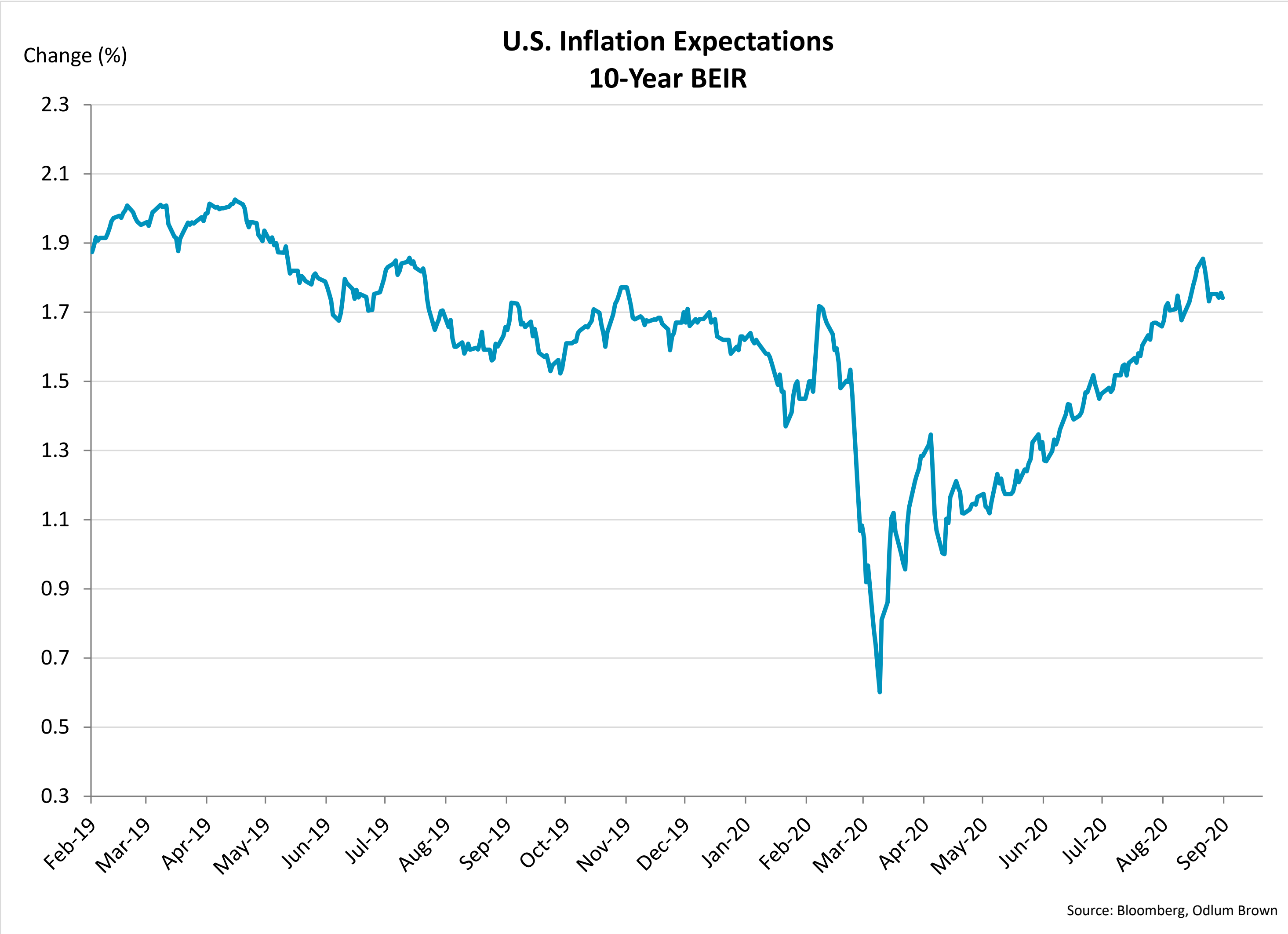
This global bellwether issue moved above its near-record low yields.



Investment grade corporate bonds reversed their improvement as U.S. Treasury yields moved up. Demand for corporate bonds remains insatiable.



The high yield market also improved steadily but has paused as U.S. Treasury yields ticked up.



Inflation expectations have moved up steadily since March but are well below 2%.

Outlook

We expect the uneven U.S. economic recovery to continue; it may begin to falter unless another round of fiscal stimulus happens but that is looking unlikely over the near term.

Following the Fed's revised approach to inflation-targeting, there appears to be a tug-of-war developing in the outlook for inflation. The evidence supporting higher inflation is visible in higher producer and consumer inflation, rising inflation expectations and firmness in commodity prices.

There remain deflationary headwinds, however, most notably demographics and technology. Much of the recent uptick in inflation may turn out to be cyclical. As well, there are skeptical analysts who doubt the Fed's ability to push inflation higher.

We conclude that inflation will continue to firm but is unlikely to breech 2%. Central Banks everywhere in the developed world have anchored short-term rates close to zero, indicating that they may keep them there for years. The massive quantitative easing program in the U.S., which entails buying $80 billion of U.S. Treasury bonds and $40 billion of mortgage securities monthly, will continue indefinitely.

Negative bond yields may ease following the bottoming of producer prices, paving the way for higher nominal bond yields. The U.S. ten-year note may move all the way up to 1%!

Consumer confidence and retail sales will be key indicators for the trend of the economy and bond yields.

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.

Primary issuance of investment grade corporate bonds and high yield bonds reached record levels in recent months. While issuance has eased from record levels, corporate CFOs continue to take advantage of relatively low funding costs.

We have long recommended the laddered approach to fixed income investing. We continue to do so. Eventually, we will turn our attention to inflation-protected bonds, once it is clear that the recent acceleration in inflation is more than cyclical.

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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