

2019 FIXED INCOME Q4 OUTLOOK



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During the third quarter, the U.S. Federal Reserve (Fed) and the ongoing U.S.-China trade saga continued to be main drivers for fixed income and global financial markets. As expected, the Fed began its easing cycle, cutting interest rates by 25 basis points (bps) in both July and September. Importantly, July's so-called "hawkish" press conference from Fed Chair Powell seemingly helped spark a bond rally throughout August in a market that was already getting primed for lower yields.

U.S.-China trade was also a key driver for global risk sentiment throughout the third quarter. U.S. President Trump's comments calling for additional tariffs on Chinese goods on August 1 – the day after July's Fed meeting – sent global markets and risk sentiment into a tailspin on the concern we were on the precipice of a significant global trade war escalation. Not surprisingly, 10-year U.S. Treasury yields fell from 2.01% to 1.50% throughout August, while the spread between 2-year and 10-year U.S. Treasuries eventually inverted, declining from 15 bps to -1bp.

It is clear that global growth is slowing and we believe it has further to go. Except for Norway and Canada, G10 central banks are already on easing paths, while emerging market central banks like Mexico, Brazil and China are also easing and, in some cases, providing additional liquidity to domestic markets. Like in the U.S., this caused most sovereign curves to rally throughout the third quarter as global investors "reached for yield." Optically important was the European Central Bank's (ECB's) September decision not only to lower its deposit rate by 10 bps to -50 bps, but also to restart its quantitative easing program at 20 billion euros per month – with no end date – and in the

process sending a clear signal to markets about its resolve to push inflation higher towards its 2% goal.

The Bank of Canada (BoC) continues to buck this global trend, with Governor Poloz and the Committee holding interest rates at 1.75% in both July and September, as expected. With a more constructive inflation picture in Canada versus the U.S., less direct impact on the economy of a global trade war and a policy rate that was already lower than the U.S. at the beginning of the cycle, we are not surprised to see the BoC lag the Fed here and continue to believe it will do so until at least the end of the fourth quarter.

Moreover, while recession whispers in the U.S. abound, we still do not see it as an imminent threat. Yes, we are getting further along in the cycle and recession risks are rising, but the U.S. labour market remains historically tight, the consumer strong, credit ample and the Fed ready to ease with its predominant mantra to do whatever it can to try and "extend this cycle." While, according to the Fed's own forecasts, it might be done lowering rates for the year, the market is priced for one more rate cut of 25 bps in the fourth quarter. We believe the Fed will do just that, if not more, in addition to providing a permanent term repo facility at its October 30 meeting.

That view coincides with our continuing expectation of a drift lower in yields from here in the coming quarter. Accordingly, we have been adding duration (i.e., increasing interest rate sensitivity) to most of our portfolios as well as shifting away from some credit names, bearing in mind the view that we are closer to – although by no means at – the end of the economic cycle. Besides actively watching the Fed this coming quarter, we will continue to watch progress

in U.S.-China trade talks, with our base case remaining a “small deal” is likely the most reasonable outcome before the end of the year, with markets having already largely priced in that scenario. In our opinion, additional macroeconomic risks abound for the duration of the year and into 2020, including the looming U.S. presidential impeachment battle, continued slowing in the global economic data, oil price disruptions and a possible no-deal (“hard”) Brexit, just to name a few.

Although a European fiscal compact is likely a few quarters away, we are keeping watch on the longer-term horizon with talk of this compact gaining momentum and with incoming ECB President Lagarde, who brings a fresh perspective, already pushing for national governments to help the ECB employ a dual-pronged monetary and fiscal approach. If successful, this dual-pronged approach could steepen yield curves in 2020. Getting the timing right will be imperative to this global reflationary trade. Details around the magnitude and scope of any package will be important for whether the market deems it as a success that can help mitigate the current global economic slowdown.

Despite the decline in North American interest rates, provincial and corporate bonds spread have been trending tighter year-to-date. The lack of new corporate issuances, as well as the low expectation of economic recession in both the U.S. and Canada, has been a major factor supporting corporate bond spreads. While corporate bond supply returned strongly in September, corporate bond issuance in the U.S. and Canada is 18% and 10%, respectively, below that of 2018 on a year-to-date basis. Provincial bond spread has benefitted from this lack of supply and has been as the next instrument of choice for investment. With the return of corporate bond supply, provincial bond spread may underperform that of corporate bonds.

Corporate credit fundamentals remain steady so far, with gross leverage remaining stable to slightly higher. However, given the backdrop of global economic slowdown (the U.S. included) and the general expectation of slower earnings growth, the risk of higher leverage increases going forward.

At the current spread level, we do not view the corporate high-grade market as cheap. As such, we continue to position defensively by a) keeping our corporate bond weight to the middle part of our usual weight range (sub-50%); b) migrating the portfolio towards higher quality (issuers with stronger credits) and liquidity (larger bond issuance size with deeper market); c) reducing exposure to non-investment-grade instruments for Core-plus funds; and d) using derivatives to hedge tail-risk events.

We are constructive on high-yield bonds and leveraged loans, and see pockets of value in certain areas of the levered credit markets with attractive valuations and strong risk-adjusted return potential. We remain focused on capital preservation as we get later in the economic cycle, and also because of tail risks, including trade disputes and geopolitical uncertainties such as Brexit and U.S. politics that look to be with us for an extended period of time. Given this backdrop, we have maintained our defensive posture with an uptick in credit quality, issuer selectivity and deal structure scrutiny. We will look to implement high-conviction ideas as opportunities arise across sectors, credit ratings and capital structure (corporates hybrids, bonds, loans). ■

Disclosure

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