Mackenzie Fixed Income Team
Q2-2019 COMMENTARY

Outlook & Positioning

During the second quarter, the bond market continued on its "reverse course" direction toward lower yields, taking its cues from weaker global growth and increasing uncertainties surrounding geopolitical risks such as trade. Reacting to these concerns and weaker domestic inflation, the Federal Reserve began to lean toward the potential for an easing of monetary policy as early as this summer.

Anticipating this movement from "neutral" to "dovish", the US bond market ended Q2 with approximately three 0.25% cuts to the Fed Funds rate priced-into the yield curve by year-end, and roughly one more reflected for 2020. Portions of the yield curve have held sustained inversions for many weeks, with the US 10-year Treasury bond dipping below 2% - for the first time since 2016 - in June.

Other major central banks have also reacted to the global slowdown, and in each case slower domestic growth and inflation rates. The ECB discussed the potential for long-term refinancing for the region's banks, as well as a possible need to move the policy rate further below zero, while the People's Bank of China boosted stimulus through additional small measures.

The Bank of Canada continued to reflect a neutral stance on monetary policy, noting in its commentary that the Canadian economy has been growing reasonably well. With the increased likelihood that the Fed will cut rates and the Bank of Canada will stand pat, the Canadian dollar rallied strongly in June. Bond yields in Canada largely tracked US yield curve movements, with portions of the curve inverting and the Government of Canada 10-year bond yield hitting a 2-year low during the quarter.

Corporate credit markets have rallied strongly along with equity markets since the start of the year. The Fed's switch from tightening to a potential easing of policy has encouraged risk-taking, as markets seem to have interpreted the Fed's policy inflection as an adequate response to the low inflation and slowing growth environment. Put another way, upcoming Fed rate cuts are thought to be "insurance" against a recession developing, in the markets eyes, and not a prelude to even more rate cuts to follow. After all, easy money policies have bailed-out markets many times over the past decade.

The recent years of low-to-negative policy rates across the world has yet to induce lasting inflation in many regions. As a result, the Fed has begun to talk about adjusting their "reaction function" to current inflation from raising or lowering the Fed Funds rate based on current inflation data and relevant measures of inflation expectations, to including where inflation has been recently on average. This change may already be entering the Federal Reserve's view on the policy rate. With many recent years of below-target inflation in the US, the Fed may now be willing to reduce and sustain the policy rate at a lower level even if inflation begins to rise again. In may be this methodological change that has had both credit and equity markets so willing to rally in the face of an inverted yield curve.

As has been the case over the last twelve months, the rest of this year looks to have many macro and geopolitical risks to contend with. While the loosening policy environment may help smooth out bumps along the way, the start of the third quarter presents us with tighter credit spreads and higher equity valuations than at any point year-to-date. In the fixed income and balanced portfolios we manage, we have been selectively reducing some credit risks while maintaining a reasonably overweight positioning in corporate debt investments.

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