Mackenzie Fixed Income Team

Q4-2018 COMMENTARY

Outlook & Positioning

- Market sensitivity to higher US interest rates, and more generally monetary policy tightening, showed through strongly in the fourth quarter of 2018. The Federal Reserve's tightening path continued through the fourth quarter as the policy rate was increased a ninth time since late 2015, to 2.50%. Chairman Powell's slight increase in hawkishness as Q4 began, when combined with the slowing global growth projections, expectations of slowing growth in US corporate profits, and the by-then significant declines in many emerging market equities and bonds, caused a sharp revaluation of US equities and high yield debt.
- For the US economy, while there are no immediate signs of economic recession to begin in 2019, some areas of the domestic economy have begun to feel pressure from the higher interest rates and yields ushered in by the Federal Reserve policy hikes over the past two years. For example, as mortgage rates moved higher through the middle of 2018, applications for mortgages fell as affordability became more challenging for a greater number of households.
- Even though some leading indicators of growth, in-particular some of the well-observed sentiment surveys, have recently come off their highs, labor indicators for the US economy are expected to remain supportive of growth in 2019. Chiefly, low unemployment and higher wages should keep consumer sentiment somewhat buoyant in the face of the fractured US political environment, and uncertainty emanating from the US-Chine trade war. So, the underlying support that drives consumption, which the most significant component of US GDP, should have growth somewhere in the 2% range for 2019.
- The market volatility of Q4 caught the attention of the Fed. As 2019 began, the Fed signaled that it will pause additional rate hikes, effectively removing the hawkish bias embraced just three months ago. Future rate movements are now dependent on emerging data evidence as to inflation trends and labor market conditions. Thanks in part to the recent drop in many commodity prices, headline inflation rates are likely to be quite subdued until much later this year, when base effects may kick in to boost price indices. The bond market, which has generally lagged the Fed's dot plot on pricing in future rate hikes, began 2019 with no rate hikes priced-in. In serves to keep-in-mind that the Fed intends to keep reducing its balance sheet throughout 2019 by allowing $50 billion of maturing bonds to roll-off. This is effectively a form of policy tightening, just as the purchase of these bonds was a form of easing after the financial crisis.
- The Bank of Canada appears likely to follow or lag the Fed on potential monetary policy hikes this year. In general, the Bank of Canada faces a more rate-sensitive economy, given the greater amounts of household leverage in Canada as compared to the US.
- Corporate credit spreads widened swiftly in Q4 as the risk-off tone was exacerbated in the low liquidity days typical around year-ends. Valuations remain reasonable for this stage of the credit cycle, which may be prolonged by the Fed pausing its rate hikes for a while. Corporate fundamentals have only weakened modestly, and do not appear threatening, given continued growth in the US. Any truce in the trade war and a complacent Fed will likely ensure that profitability remains high and debts manageable. Nevertheless, we will be approaching this stage of the credit cycle with a degree of cautious optimism, and an expectation that additional market volatility will be a part of the valuation picture we need to discount.

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