Mackenzie Fixed Income Team

Q1-2019 COMMENTARY

Outlook & Positioning

The equity and credit market volatility of Q4 2018 made a complete 180 degree turn in the first quarter of the new year. While a fair amount of the blame for the sell-off that ended 2018 lays at the feet of the Federal Reserve and its hawkish monetary policy stance at the time, the ensuing bounce this year is mainly thanks to the Fed's "dovish" pivot. Starting early in January, the Fed successfully calmed the markets' collective nerves with soothing statements, and followed this up with actions. At the March FOMC meeting, the official statement and press conference effectively communicated that future rate hikes in 2019 are unlikely, and accompanying this was a slight downgrade to the Fed's GDP growth estimate for the year, and a pronouncement of an end to the balance sheet reductions ("quantitative tightening") in September 2019.

Much attention has been paid to the flattening of the yield curve over the past year. In prior economic cycles, an inverted government bond yield curve (short term yields greater than longer term yields) that appeared after years of economic expansion and many quarters of the Fed raising the policy rate, has seemed to presage a downturn in the economy and equity markets. The Fed's recent dovishness has encouraged the bond market to not only completely eliminate (price-out) additional rate hikes, but to also go so far as to "price-in" a high probability for a 0.25% rate cut over the next twelve months. This has induced an end-of-the-quarter inversion of the curve between the Fed Funds rate and the 5-year bond yield.

Recent weakness in the global economy emanating from many regions is also a significant contributor to the bond market's Fed outlook. Equity and credit markets are not currently reflecting nervousness about the end of this economic expansion, having rebounded throughout the quarter. So, does the stock market have it right, or is the bond market's view of a needed rate reduction the correct call? What the two markets have in common is a positive reaction to the Fed's pause, and in the case of the bond market, there may be some technical components that have caused an inversion in recent weeks.

The next set of market reactions may hinge more on how certain geopolitical risks are dealt with, as well as continuing stimulus from fiscal sources. Brexit, US bi-lateral trade disputes with various countries, and China's attempts to target stimulus are issues that, if mitigated sufficiently in the near term, could be enough to provide a path to a soft landing and reinvigorate business spending in the second half of the year. This soft landing could occur without the need for Fed rate cuts. Any resumption of rate hikes is now likely to occur only after the economy has shown renewed strength, and an above target inflation rate has persisted for a short period of time, in our opinion.

Corporate credit markets look poised to generate reasonable, coupon-like returns for the rest of the year, on-balance, after a tremendous start, provided that none of the geopolitics get in the way. It is likely some companies have delayed capital investments due to uncertainties surrounding supply chain management given the trade tariff escalations of the past year. Non-financial corporate debt has increased this cycle, however even with moderate economic growth most companies will continue to have little trouble servicing their debts.

For the global economy, total debt has increased markedly during this cycle. The debt outstanding may create a drag on potential growth, and any material increases in bond market yields could push debt-service costs beyond tolerable. As the slowing global growth rate and volatile markets have shown us over the past few quarters, rising bond yields and policy rates can quickly produce headwinds even from what are historically considered low prevailing yield levels.

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