Provisus Wealth Management

Q4 2018

Quarterly Commentary

Multi-Strategy High Yield

The Canadian FTSE TMX Universe Bond Index gained 1.8% in the fourth quarter of 2018 and was up 1.4% for the year. Over the course of 2018 the Bank of Canada raised rates in July and again in October, bringing the Canadian interest rate benchmark to 1.75%. In the U.S., the Federal Reserve increased its benchmark interest rate in December. It was the fourth quarter-point rate hike in 2018 and pushed the target range to 2.25% to 2.5%. The recent increase was the ninth rate rise since the U.S. began raising rates in December of 2015.

The most recent Canadian rate increase was announced on October 24 in a Bank of Canada statement and confirmed that that the bank felt comfortable with the economic outlook now that politicians in Canada, Mexico and the U.S. had agreed on the revised trade agreement. That evidence suggested that Canadian households were adjusting to higher borrowing costs. The central bank's policymakers raised their outlook for business investment and exports, which suggests that the economy is becoming less reliant on debt-fuelled spending and the housing market.

Canada's economy is growing somewhat faster than the Bank of Canada predicted a few months ago and "vulnerabilities" from elevated levels of household debt are "edging lower," according to their statement. Policymakers reiterated that interest rates must rise and offered a more definitive notion of where it wants to go. Additionally, the statement notes "Governing Council agrees that the policy interest rate will need to rise to a neutral stance to achieve the inflation target." The Bank of Canada's Governor Stephen Poloz has talked about returning interest rates to a level that economists associate with normal, a place where the cost of money is neither stimulating expansion nor curbing growth. The central bank estimates that the "neutral" interest rate is something between 2.5% and 3.5%. The statement confirmed that the pace of interest-rate increases will be determined by "how the economy is adjusting to higher interest rates, given the elevated level of household debt" and "global trade policy developments." The resolution of the trade dispute is a relief but the central bank expressed heightened concern of the U.S. trade war with China.

In December the U.S. Federal Reserve announced a widely expected quarter-point increase in its benchmark interest rate and signaled that it plans to continue raising rates this year. The decision to raise rates for the fifth consecutive quarter, by a unanimous vote of the Federal Open Market Committee, amounted to a rejection of the view that the Fed should hold off raising rates in order to help prop up the economy in hopes of increasing employment and wage gains. The statement made no mention of turbulence in the financial markets, however Fed Chairman Jerome Powell did say that the central bank is very close to the range of neutral-rate estimates, a sign that the central bank may back off its plans to normalize interest rates this year as the outlook for growth has increasingly migrated to one that includes a mid-cycle slowdown.

Optimism over the inflation outlook, solid economic growth and a consensus that the Federal Reserve would raise rates at least one more time this year had played a part in keeping long-dated yields generally above the psychologically significant 3% threshold in the U.S. for most of the year. The yield curve, the difference between long and short term interest rates, remains in a bullish zone, although that positive margin has been narrowing and warrants close watching. Though doubts over the global economy's health are growing, the 10-year note yield had bucked the atmosphere of economic pessimism. Treasury yields are starting to indicate that investors are harbouring greater worries about the fragility of a roughly 10 year economic expansion, however the overall tone of the Fed's statement suggested that it continues to regard current growth as more impressive than any storm clouds on the horizon. That continued optimism portends additional increases are likely, despite market gyrations and signs of economic weakness.

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