Quarterly Commentary

Multi-Strategy High Yield

During the second quarter of 2019 the Canadian FTSE TMX Universe Bond Index gained 2.5% and has risen 6.5% so far this year. Bonds have rallied as expectations for future central bank interest rate hikes have fallen dramatically. A few months ago there were expectations for a series of hikes but we have not seen any changes to base rates so far this year in the U.S. or Canada. 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 2018 to the target range of 2.25% to 2.5%. Major central banks have remained accommodative as global inflation has remained low and global growth is moderate. In Europe, the European Central Bank is not expected to hike rates in the near term. In China, policy is expected to remain easy but authorities there are cautious as financial conditions could become too stimulative.

Canadian interest rates are almost certainly on hold until at least 2020. The Bank of Canada published a revised outlook that showed that the economy stalled at the end of 2018 but the bank's 2019 Financial System Review also found that progress has been made on two key factors, household debt and housing affordability. The challenges associated with high household debt and imbalances in the housing market have declined modestly. The share of Canadians falling behind on their debt payments remained relatively low while housing resales and price growth have slowed significantly in Toronto and Vancouver over the past two years. These factors are alleviating some of the policymakers' concerns over inflation. Their policy announcements do not suggest that interest rates would rise in the foreseeable future.

Gross domestic product was growing at an annual rate of 2% in the third quarter of 2018 but then decelerated to rates of 0.4% in the fourth quarter and 0.3% in the first quarter of this year, according to the central bank's quarterly Monetary Policy Report. Governor Stephen Poloz noted that the central bank had allowed for a slowdown due to lower oil prices but their expectations for strength in non-energy exports have disappointed. Both have struggled and are robbing the economy of an offset to the falling investment in real estate and weaker household consumption. The Bank of Canada predicts a rebound will be ignited by growth in the second quarter but the recovery likely won't be big enough to offset the damage already done. The central bank now predicts GDP will expand by a tepid 1.2% in 2019. That means there is little danger of the economy generating rapid inflation and explains why policy makers stopped talking about the need for higher interest rates.

In the U.S. the Federal Reserve got some attention in late June for putting out a statement which seemed to change its previous promise that it would be "patient'' before cutting interest rates. The market took that to be a call for an imminent rate cut, however the Fed Chair, Jerome Powell, followed up with a press conference where he pointed out that the most recent data, such as the June retail sales report, were quite a bit better than expected. He noted that consumer spending is more than two-thirds of the economy and that the service sector is strong. To be sure, there are problems as there were signs of weakness in business investment in the second quarter, especially in manufacturing. There are also concerns about weakness overseas, which may be partly due to China trying to reduce its debt load and growing more slowly. Another is cheaper oil but cheap gasoline means consumers have more money to spend on other things. There is also a risk to global supply chains and these events do bear monitoring but if the economy keeps chugging along it will be hard for central bankers to cut rates without signs of declining inflation.

The market has long feared the end of the ten year old expansion but the odds of a recession this year are still quite small. Economic expansions are not limited by time as demonstrated by Australia which has now gone 27 years without a recession. In North America consumer balance sheets are fine, the job market is in decent shape and there's little inflation to be found. At this time there don't seem to be any compelling reasons to break out of the current steady interest rate scenario.

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