Quarterly Commentary

Multi-Strategy High Yield

The Canadian FTSE TMX Universe Bond Index rose 1.2% in the third quarter of 2019 and the index has risen 7.8% so far this year. The Bank of Canada kept its benchmark interest rate steady at 1-3/4% at its September 4th meeting, as was widely expected, and the rate remains at its highest since December 2008. The central bank is almost ready to join the other major central banks in cutting interest rates, but not yet. The consensus agreed by Governor Stephen Poloz and his deputies was to leave the benchmark rate unchanged until at least the end of October.

In a speech to the Halifax Chamber of Commerce on the day after deciding to hold interest rates steady, Deputy Governor Lawrence Schembri discussed the key points the Governing Council considered in their decision. He explained that the Canadian economy continued to show strength despite the weakening global backdrop. The Canadian data since July has been stronger than the bank had anticipated as wages picked up and the housing market rebounded. Overall consumer spending though has been softening and business investment is weakening so the economy is expected to slow over the second half of the year. The U.S. / China trade war was the main risk to the central bank's outlook in July and it has gotten worse since then, taking a toll on global economic growth.

The decision implies that policy makers think there is enough stimulus in the system to counter the effects of the trade wars for a little while longer. "Canada's economy is operating close to potential," the Bank of Canada said in its recent policy statement. "However, escalating trade conflicts and related uncertainty are taking a toll on the global and Canadian economies. In this context, the current degree of monetary stimulus remains appropriate." That existing stimulus separates Canada from some of the countries where central banks have been cutting rates.

In the U.S., the Federal Reserve cut its benchmark interest rate in September. The rate reduction was the second since December 2008 when the Fed dropped its benchmark effectively to zero before initiating a series of nine raises that ended in December 2015. While the domestic economy has performed relatively well, the Fed cut rates amid concern that softness abroad threatens the decade-long U.S. expansion as President Trump's trade war with China is hurting foreign demand.

The Fed's moves are part of a trend around the world as 16 central banks lowered interest rates in the third quarter. Some analysts expect that another two dozen more central banks could slash rates in the fourth quarter and there are concerns that yields on U.S. bonds could turn negative. Negative interest rates represent a threat to the financial system because it operates under a fractional reserve banking mechanism where banks deposit a percentage, usually about 10%, into a central bank reserve account and the rest is either lent out or used to buy securities. This works when rates are positive and banks earn income on deposits but in a negative rate environment the bank must pay to hold loans and securities. In other words, banks would be punished for providing credit, which is the lifeblood of an economy.

Valuation models are another area of finance that will need to be reconsidered in a negative rate environment. Noble prizes have been awarded to economists who developed financial pricing models, but when a negative value is assumed for the risk-free rate the fair value calculation shoots off to infinity. To see the results of low or negative rate environments, look no further than the Eurozone and Japan as they account for 87% of the negative rates worldwide. Europe is essentially in recession with negative GDP in Italy and Germany; and in Asia, Japan is not doing much better. The U.S., UK, Canada, Australia and New Zealand are the only developed bond markets that do not currently have negative rates anywhere on their yield curves. If these countries also move into negative rate territory, the financial system will be under even more stress so these developments should be watched closely.

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