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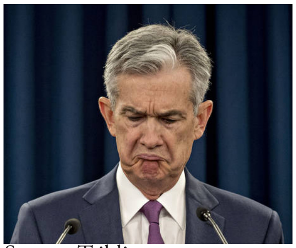
Private Wealth

CUMBERLAND FIXED INCOME FIRST QUARTER REVIEW

Peer Pressured?


Source: Triblive.com

Once January 1st hits everyone knows that the days ahead are likely to be long, dark and cold – welcome to Canadian winter. This year was no different. Mother Nature was not the only one to bring on an early winter depression particularly in the US: about 25% of US government employees started the year with no pay cheques since December 22nd and it was unclear when the government shutdown would end; the equity markets were at a 52-week low (though the S&P 500 was only down 4% for 2018, the sell-off in Q4 sounded alarm bells of a 2008 repeat); and trade wars between US/China continued to elevate while another battle with US vs. Europe was starting. Not to mention global growth fears, unresolved Brexit and Canada/China relations added to more uncertainty.

I point to my year end commentary, entitled "How did we get here? Negativity is Contagious," as a first read for some background.

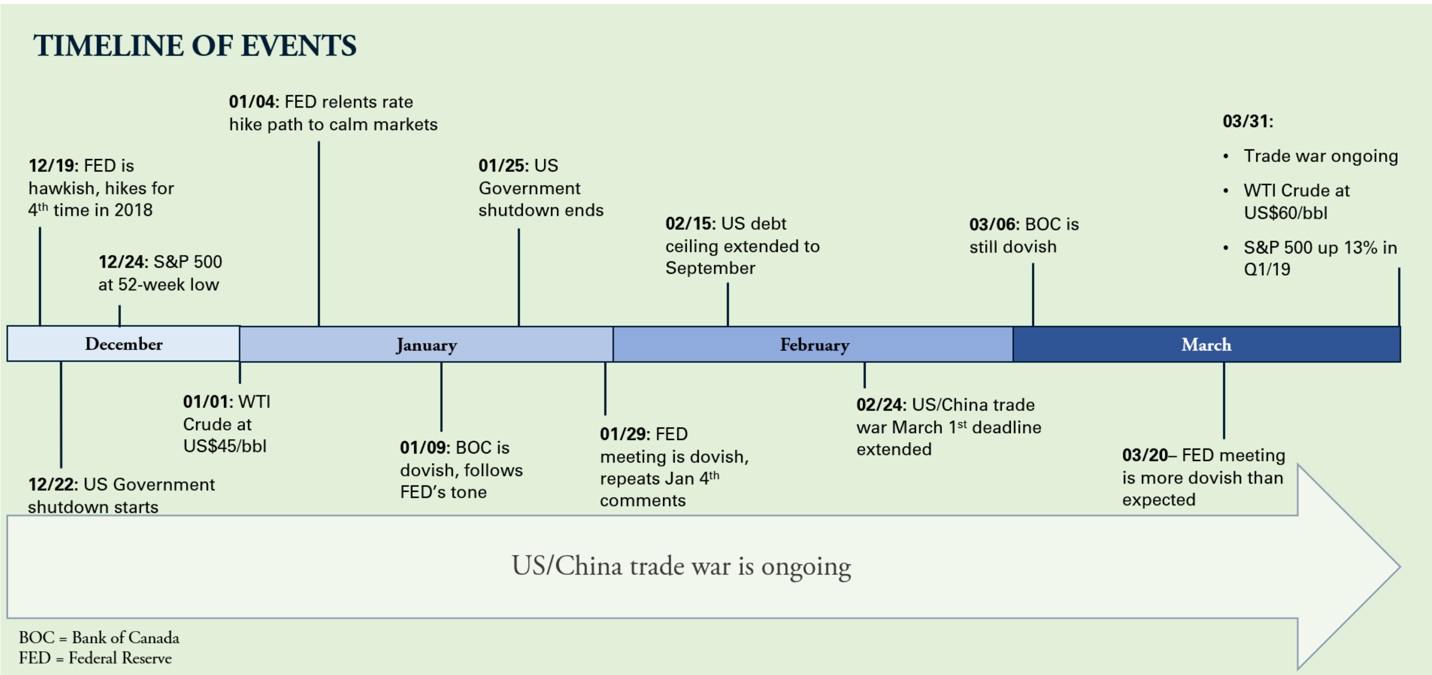
As a reminder, on December 19th, the FED had increased interest rates for the 4th and final time for 2018. During that same meeting, the FED signalled potentially another two interest rate increases in 2019 which caused more nervousness in the markets. Note that the market had started 2018 with an expectation the FED would increase interest rates 6 times – so technically the FED 'under'-hiked in 2018.

As we entered the holiday season, it was far from cheerful as many felt depressed by their realized and/or paper losses. Pressures on the Federal Reserve continued to mount for increasing interest rates too aggressively and causing a potential economic slowdown because of it. Over the 2-week holiday period and into the new year, equities continued to sell off with no end in sight. The FED consistently reiterated it was data dependent. However, by January 4th, not even during a planned FED meeting slot, the FED regressed and signalled it would put rates on hold; only 2 weeks after its last meeting in December, with no new data released, other than market fears of a "2008-like recession" repeat.

So, how did the first quarter end? The longest US government shutdown in history ended when the government pushed out their debt ceiling problem another 6 months and without a solid resolution on a border wall (the highly contentious issue that prolonged the end to the shutdown). The S&P was up 13% (or up more than 7% from the start of 2018) with the biggest quarterly gains in nearly a decade. China/US started to be more cordial in their negotiations realizing a deal is required as their decisions will have an impact on global growth. Brexit continues to be in limbo as it was pushed out from its March deadline to mid-April. Global growth was revised downward (but mostly from all the uncertainty of what will spill from these trade wars). The uncertainty is still there but everyone is trying to co-operate to make things work.

During its March meeting, the FED took a further step of caution: reducing its dot plot to no hikes (from one to three hikes) in 2019 and only one more hike through to the end of 2021. This was more dovish than investors had expected.

Other central bankers around the world felt more compelled to follow the US and hold their interest rate policies steady. Canada specifically will hold its overnight rate steady, until there is more certainty, not just domestically but globally.

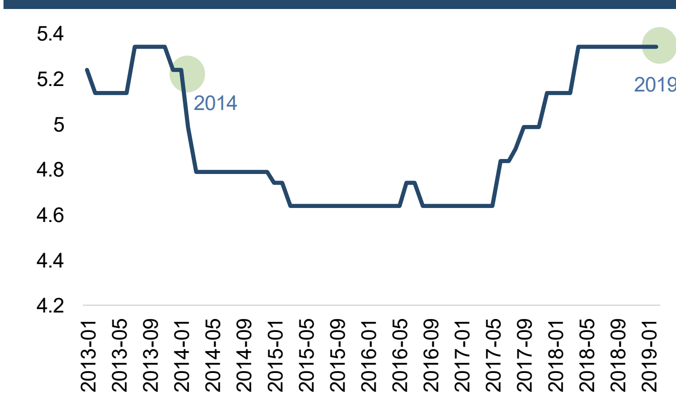


The Boy Who Cried Wolf? Are We Worse Off?

After hearing time and time again, that interest rates are higher and hurting consumers and corporations, I wanted to understand by how much. Debt has fuelled this 10-year long recovery: Does the Bank of Canada need to hold back because higher rates will lead us into another recession?

Firstly, let's start with the overleveraged Canadian consumer. The largest debt component of any Canadian is typically a mortgage. Are consumers worse off after these interest rate increases? Since we have seen a net of 3 interest rates increases (ie. 75bps) over the past five years, we should assume the consumer would bear the brunt of those costs. From the Bank of Canada website, 5-year conventional mortgages rates show that existing homeowners who entered into a mortgage in 2013/2014 (ie. 5 years ago) and who had to renew over the course of these interest rate increases, would have locked in potentially lower or marginally higher (10bps -20bps) interest rates and not the full 75bps increase yet. Of course, for those who entered into shorter term mortgages or a floating rate mortgage would see higher rates today. Consumers renewing today and in 2019 will surely see a higher rate. Payments would not change but amortization of principal would be lower.

Exhibit 1: Canadian Conventional 5-Year Mortgage



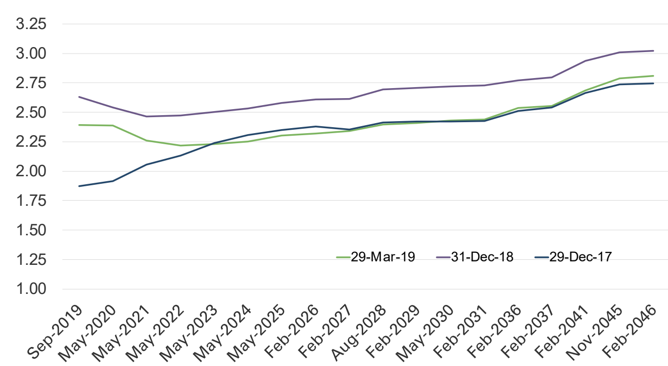
Source: Bank of Canada

Now for Canadian corporate issuers, the first quarter saw over-subscribed issuance as there was pent up demand from the lack of issuance in Q4/2018. Many companies that came to market were looking to refinance existing maturities. For companies that were stable credits (ie. credit rating unchanged, not on negative outlook), they saw anywhere between 8bps to 618bps of savings (with the majority in excess of 100bps). For those that are deteriorating in terms of their credit fundamentals, had been downgraded or were issuing product at a lower rating than in the past, it cost companies anywhere between 11bps to 257bps (with majority below 100bps). Given 2018 saw three interest rate hikes, the incremental costs for companies that saw deterioration in their balance sheets was not so detrimental! Rather, the market is not being punitive at all for having higher leverage! There is no incentive to deleverage! It does not look like we are worse off (yet).

Quarterly Review

While the FED relented and put a hold on interest rate increases, its messaging to the bond market brought more fear than relief: did they know something more than everyone else did? Skeptics were concerned that with the FED taking a 180 degree change in a matter of two weeks (between December 19th to January 4th), further dovish commentary in their March meeting and mixed economic data over the quarter, a recession could be brewing. As a result, yields moved lower by 15bps to 30bps across the yield curve in the first quarter.

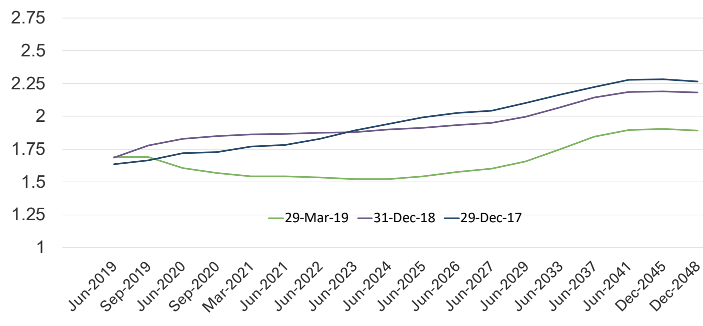
Exhibit 2: US Yield Curve



Source: Bloomberg

Viewing the US as its big brother, Canada also followed its lead in changing gears to holding interest rates steady. The Canadian yield curve also moved lower anywhere between 9bps to 38bps across the curve.

Exhibit 3: Canada Yield Curve



Source: Bloomberg

There were, however, some positive signs at the end of the quarter as WTI crude was steady at US$60/bbl (rebounding from a low of US$45/bbl at the start of the quarter) and January GDP was better than expected. It brings some hope for the spring.

Canadian investment grade corporate spreads compressed anywhere between 15bps to 28bps across the curve and rating categories, driven by the very robust demand as investors needed yield.

Returns for various fixed income asset classes are in the table below. During the quarter, long government bonds outperformed as a more dovish FED left investors skeptical of a potential recession and while government bonds outperformed, risk products such a corporate bonds and high yield bonds also performed well as investors searched for yield.

Asset class returns	Q1/19	Q1/18	2018	2017
Bond Universe Index	3.91%	0.10%	1.41%	2.52%
Corporate Bond Index	4.03%	0.28%	1.1%	3.38%
Short Term Bond Index (1-5 Years)	1.74%	0.22%	1.91%	0.08%
FTSE High Yield Canadian Index	4.02%	0.91%	2.15%	9.94%
S&P/TSX Preferred Index	1.38%	-0.40%	-12.21%	13.44%

Outlook and Positioning: Rewardless Risk?!

As we are protective of our clients' capital, we continue to believe short duration makes sense.

We continue to harp on the fact that the yield curve is so flat and while longer bonds have outperformed Q1, we conclude that it could be rewardless risk rather than riskless reward. Just very simplistically, at the end of this quarter, 30-year Government of Canada bonds yielded investors 1.89% (annually), while the 1-month bank CDOR rate was 1.98% (annualized). While the former exposes the client to interest rate risk (30 years), the latter exposes the client to bank risk but for a shorter time frame. Volatility of returns would be higher for the former than the latter. Given the uncertainty of these unresolved global issues, that volatility could be more punitive than rewarding to investors.

We enter Q2 in a very low interest rate environment, lower than this time last year (and even after 3 interest rate increases in 2018). The Canadian government can now make money by borrowing (ie. issuing 10-year government bonds to investors like you and me) and parking it in the bank for almost +14bps return! A bit absurd. Hence, we continue to stay disciplined in balancing the risks for our unitholders.

I hope to see you at the next event. Take care,

Diane

Diane Pang
Lead Manager,
Cumberland Fixed Income*
April 2, 2019

*Cumberland Private Wealth refers to Cumberland Private Wealth Management Inc. (CPWM) and Cumberland Investment Counsel Inc. (CIC). CIC acts as sub-advisor to certain CPWM investment mandates including the CPWM Fixed Income mandate with Diane Pang as its lead Portfolio Manager. Diane Pang is a Portfolio Manager at CIC.