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Private Wealth

CUMBERLAND FIXED INCOME SECOND QUARTER REVIEW

Who's Got P WE~~LL~~R?

Source: Google Images

Most of us will remember Q2 as action-packed with highs, lows, explosive plays, trash-talking, team effort and finally, victory: Yes, the TORONTO RAPTORS are the NBA champions! Who would have thought that the underdogs would gain NBA power? Now that the playoffs are over, the 56% of us Canadians that tuned in to cheer for our beloved Raptors are now dragging our feet to get back to things we have sidelined. The financial markets had a very similar quarter to that of the Raptors' fans.

The Play-by-Play for the Quarter

Highs - S&P 500 hitting a 52-week high (again) during the quarter as economic data in the US remained robust with GDP growth still above the 3% (for now), unemployment at historic lows at 3.6% and inflation (CPI) tracking within the Fed's 2% target. Canada is also showing signs of positivity with an improving GDP, solid CPI print, oil hitting a year-to-date high during the quarter of USD$66/bbl, and a 10-year low unemployment rate of 5.4%. Given the backdrop of trade wars causing instability, both economies are faring well.

Lows – Manufacturing sentiment is low! New York Fed Empire State Manufacturing Survey's last reading in June was the lowest level since October 2016, while Philadelphia's was the lowest since February, resulting from the impact of heightened trade concerns during the quarter.

US 10-year treasuries and Canadian government 10-year bonds both hit 18-month lows during the quarter: despite both the Fed and Bank of Canada indicating they will be on hold with interest rates. 2-year rates are below overnight by 50bps and 25bps for the US and Canada, respectively (ie. indicating 2 and 1 interest rate cut).

Explosive plays - Countries around the world thought they could hide in the shadows of the US/China trade war spotlight as the US and China see-sawed over whether or not to meet in early May. In the end, the meeting was inconclusive and left an overhang of uncertainty as investors fled to safety in the bond markets. By the end of May, Trump pulled out the unexpected and went on a 4-0 run (during a 5-day span from May 29th-June 2nd) against:

1. European Union – escalated on-going disputes with threats of penalties for trading with Iran;
2. Mexico – threatened 25% tariffs on imports if illegal migration didn't stop;
3. India – removed India from developing countries list that receives special trading privileges; and
4. Australia – "considered" putting tariffs on aluminum before it was quashed by the Pentagon.

These daily threats during that period caused major concerns for the markets as fixed income investors continued to flee into safe assets. Note: Year-to-date, the 10-Year US treasuries yields swung 80bps from peak to trough, in pure return, that is a move of 29%! While year-to-date, the 10-year Government of Canada bond yields swung 61bps from peak to trough, a move of 30%. Those are not the types of moves us bond investors can stomach, afterall, we are (relatively speaking), risk-averse people that are not as flashy for adventure as our equity peers.

Trash Talking

Exhibit 1: Trump's Twitter

Source: Twitter

While there continues to be critical comments from Trump regarding the Fed and their decisions with monetary policy, at the end of the day, Trump cannot fire the Fed Chairman, Jerome Powell, without cause. Powell is untouchable (really). Although, I guess Trump could find a loophole. Regardless, Powell has explicitly stated he will battle this out until the end (of his 4-year term). Powell also noted that "*the Fed is insulated from short-term political pressures – what is often referred to as our independence… Congress chose to insulate the Fed this way because it had seen damage that often arise when policy bends to short-term political interests*". Powell is focused on his task at hand: to set good monetary policy that will help prolong expansion in the US.

Team Effort - Q1 quarterly reportings were rather positive during Q2 and economic data was mostly optimistic; however, the on-going trade wars in the background were and still are a big question mark. Central banks around the world are all banding together and trying to be "accommodative" and will do what is necessary to stimulate their respective economies. The US and Canadian central banks have indicated they will be on hold, but will "act" if required and are closely monitoring the "situation" (aka. US/China trade war) to see if their economies are slowing faster than wanted.

Does this mean a race to 0? If you look at the table below, the US has the highest overnight interest rate vs. all the other G7 countries. Lower interest rates do not necessarily mean economic stimulation at this point. In Canada specifically, household debt to income is at 173%. Lower rates could just entice Canadians to borrow more and the risk would be overleveraging the consumer that it could exacerbate defaults if the economy sees weakness. Interest rate policy also affects currency, and if other countries cut interest rates, the US or Canada could see their currency appreciate, which could make exports unfavourable. As a result, if the US starts cutting interest rates, we may see Canada follow suit. The US is our largest trading partner, and a strong Canadian dollar vs. the US would make it unattractive for the US to import Canadian goods, therefore impacting our GDP.

Exhibit 2: Overnight Interest Rates

	Overnight Rate	Next Meeting
United States (lower bound)	2.25%	31-Jul-19
Canada	1.75%	10-Jul-19
European Central Bank*	0.00%	25-Jul-19
Bank of England	0.75%	01-Aug-19
Japan	-0.10%	20-Jul-19

* Inclusive of France, Germany, Italy
Source: Bloomberg

Victory - We are half way through the year, and as investors, if you stuck through the season and kept your money invested, you would be pleased with the balances in your accounts at the end of Q2. What a comeback from year-end!

Things that were sidelined

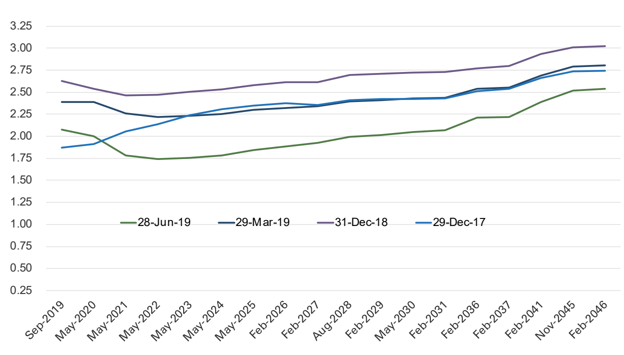
- US/China trade war resolution since the 6-week stalemate in mid-May.
- Ratification of USMCA *(United States-Mexico-Canada Agreement)*
- Brexit/No Brexit/UK elections
- US debt ceiling (that will come back in Q3)
- OPEC oil supply/cuts

Quarter Review

During their most recent meeting in June, the Fed continued to indicate that they will be on hold with interest rate hikes or cuts, but would be accommodative, acting if necessary to prolong the US expansion (ie. cut interest rates if and when it sees fit). While their latest assumptions in their dot plot showed that interest rates will be on hold for the remainder of the year, the market is expecting the Fed to cut at least once if not more by the end of 2019.

With a very volatile May, investors fled to safety assets causing the yield curve to move lower during the quarter anywhere between 27bps to 48bps. We note there is an inversion between the 1-year and 3-year part of the curve (ie. investors would be compensated more to be in a 1-year bond than a 3- year bond).

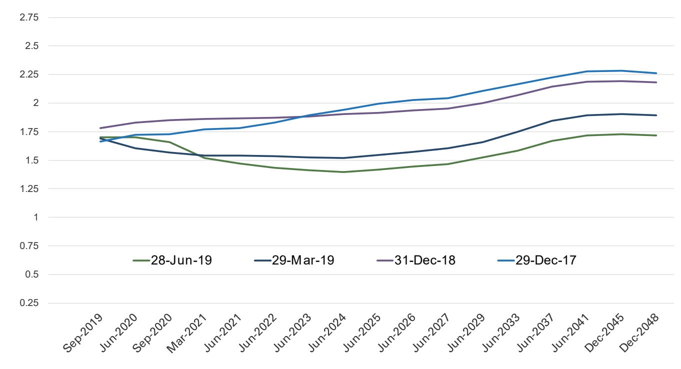
Exhibit 3: US Yield Curve



Source: Bloomberg

Canada typically follows the lead of the US; however, due to some improving economic data in Canada, it was torn directionally how to react. As a result, the move was slightly different: we saw 1 year rates move higher 10bps while the rest of the curve was lower anywhere between 7bps to 18bps.

Exhibit 4: Canada Yield Curve

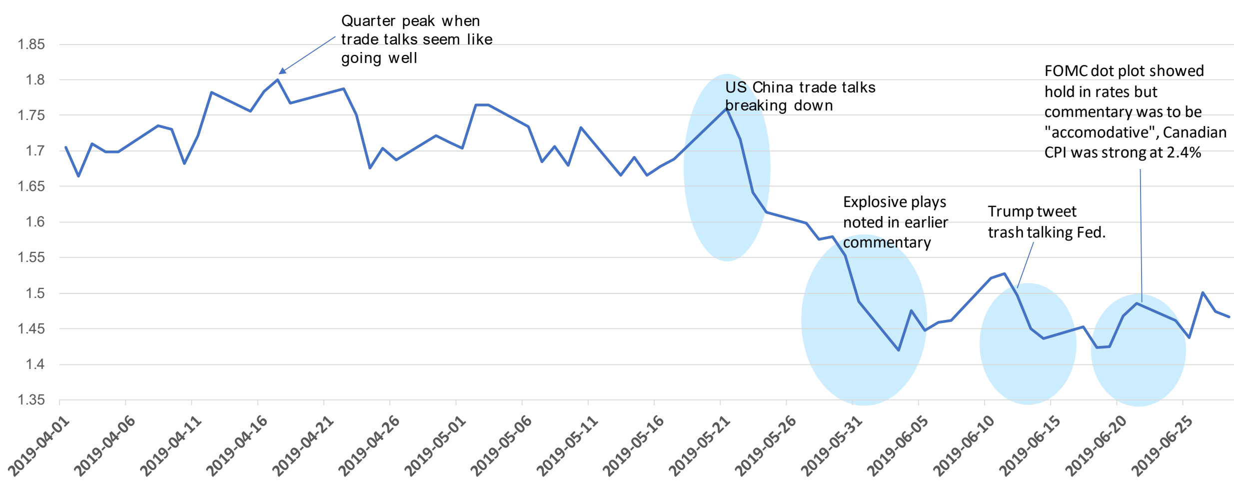


Source: Bloomberg

The volatility of the 10-year government of Canada yield index (Exhibit 5) moved from peak to trough 21% during the quarter, mainly from the news linked to our southern neighbours. This is interesting to see given moves like this are pretty big for bond investors.

Canadian investment grade corporate spreads compressed anywhere between 9bps to 20bps across the curve and rating categories, driven by the need for yield.

Exhibit 5: 10-Year Government of Canada Yield Index



Source: Bloomberg

Returns for various fixed income asset classes are in the table below. During the quarter, long corporate bonds outperformed as heightened uncertainty from the stalemate in US/China trade war negotiations lead investors to safe assets, combined with the need for yield.

Asset class returns	Q2/19	Q2/18	2018	2017
Bond Universe Index	2.51%	0.51%	1.41%	2.52%
Corporate Bond Index	2.68%	0.42%	1.1%	3.38%
FTSE High Yield Canadian Index	0.85%	1.33%	2.15%	9.94%
S&P/TSX Preferred Index	-2.69%	1.01%	-12.21%	13.44%

Outlook & Positioning: What goes up must come down

This world is far from perfect at the moment and our Canadian bond markets seem to heavily revolve around our neighbours south of us; however, what can you expect when it is the world's richest consumer market, as well as the world's largest bond market. Global GDP is impacted by US' consumer behaviour which in turn impacts Canada's GDP and the outlook to our economy. Bond markets are fluid as international flows out of and into the US could mean flows into and out of Canada (maybe not to the same extent of volumes, but to the rest of the world, we are viewed as the smaller, more conservative sibling). While we'd like to think Canada is independent (152 years!), we are so tied in many ways to our older and bolder sibling, so keeping abreast on their ways will help us in deciding how we should deal with our own markets. Divergence in monetary policies between the two countries is not out of the realm of possibilities, but we would need the see a pick-up in commodity prices (not just oil), a stabilized Canadian currency along with growing exports, and continued strength in our employment rate.

With the continued rally in bonds in Q2 driving yields lower, bond prices are higher (ie. above par – which is 100). In the Canadian Bond Universe out of the 1,469 bonds, about 1,394 (or approximately 95%) of the bonds are currently trading above par. Unlike our equity peers where there is no limit to how high a stock can go, in bond land, it is very different: bonds mature at par- what goes up must eventually come down. We are cautious of that.

We continue to stay disciplined and focused on preserving capital and managing risk/rewards for our investors. While there are risks still looming in the economy and we are cautious of overreaching for yield (especially in a low interest environment), we are, at the same time, not shying away from looking for opportunities to diversify, improve the quality, and/or enhance the yield stability in the portfolio – it just has to make sense! While the traditional bond markets may not provide great opportunities at the moment, our mandates have always been very flexible and have always allowed for non-traditional debt investments to diversify and enhance the portfolio, which we have used and will continue to take advantage of. In either respect, whatever we invest in, patience is key – it is a long season.

We head into Q3 wiser, refreshed, armed and ready for more action. Enjoy the summer and I look forward to seeing you at the next client event!

Take Care,

Diane Pang
Lead Manager,
Cumberland Fixed Income*
June 28, 2019

*Cumberland 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.