For the week ending January 12, 2018.

The slow bleed in Government bond prices continued this week. Ten year Government bond yields in Canada, the U.S., UK and Germany rose 4-14 basis points, with Canada being the outperformer and Germany the underperformer. There was some fundamental rationale for the move, but technicals and headlines also played a role. Here is how we would break it down:

Fundamental

- Canada – strong Bank of Canada business outlook survey
- U.S. – strong retail sales and core CPI data
- Europe – strong retail sales and industrial production data, and modestly hawkish minutes from the European Central Bank

Technical

- Europe – heavy sovereign bond issuance
- U.S. – U.S. Treasuries: 3/10/30 bond auctions and heavy new corporate supply

Headlines

- Japan – Bank of Japan may have purchased less long Japanese Government Bonds in Quantitative Easing
- China – State Administration of Foreign Exchange may purchase less U.S. Treasuries for foreign reserves
- Canada – Trump threatens NAFTA withdrawal
- U.S. – Bill Gross projects bond bear market

Essentially, everything this week was "bond-bearish". (The one exception was the NAFTA headline, as it gave the Canadian market a strong bounce on the view that the Bank of Canada may be more cautious in tightening monetary policy. Hence, the Canadian market outperformed on a relative basis.) So, why am I making the effort to detail it all? Because some of it, especially the fundamental stuff, is meaningful. The technical items are short term influences and, frankly, the headlines are mostly nonsense. Nonetheless, they all played a role in increasing downside volatility in Government bond prices and, at some points, created a frenzy in the financial media about the impending doom in the bond market. As a result, I think it is critical to separate fact from fiction. Yes, some central banks are tightening monetary policy and as a result Government bond yields are rising. However, the bond market has a considerable amount of this already priced in for 2018. For instance, the forward curve in the U.S. has 2 rate hikes already priced in. In Canada, there are three priced in. Central bank policy would have to be considerably more hawkish in order for bond prices to decline substantially. In our view, given current and expected inflation dynamics, global growth prospects and aggregate debt levels, this process of tightening will be gradual. Government bond prices do not just go higher in a straight line and bond funds do not automatically produce negative returns in such periods. Bond price volatility in a rising rate environment has to be actively managed and good active management along with carry- and credit-alpha, can produce respectable risk-adjusted returns. Below, we articulate our outlook for markets and returns for 2018.

The good news this week was the bid in investment grade corporate bonds. The higher Government bond yield environment encouraged strong buying from both domestic and foreign accounts. A large amount of the buying that took place in the U.S. credit market was for 30 year bonds. As this buying took place, sectors that have recently underperformed, such as Telecom, were outperformers. Cash credit spreads in the U.S were 2-8 basis points tighter. In Canada, spreads were generically about 3 basis points tighter with energy being a modest outperformer. European credit mimicked the Canadian market. Notably, cash outperformed the credit indices which were unchanged to even, a basis point wider.

Secondary spreads in Canada were aided by the new issue market. This week's issues were heavily oversubscribed and tightened 3-5 basis points upon pricing. This had a knock-on effect on the secondary market as noted above. The investment grade corporate new issues in Canada this week can be summarized as follows:

- Manulife Bank $500mm 2.844% 01/12/2023 +85.7 bps
- Choice Property REIT $300mm 3.01% 03/21/2022 +103.5 bps
- Choice Property REIT $350mm 3.546% 01/10/2025 +143.4 bps
- John Deere Canada $300mm 2.70% 01/17/2023 +72.2 bps

The First Asset Investment Grade Bond ETF (the "Fund") did not participate in these new issues.

Portfolio Transactions

We sold our entire position in Constellation Brands 2022 bonds based on both, valuation and NAFTA risk (Constellation Brands has large production facilities in Mexico). We added U.S. dollar denominated new issue positions in Sumitomo Bank 2028 bonds, Crown Castle 2023 and 2028 bonds, and Tencent 2028 bonds. These were purchased by selling equivalent duration U.S. Treasuries held by the Fund.

We adjusted Fund duration on four occasions this week utilizing U.S. Treasury 30 year futures contracts. Each of these trades was unwound at a profit.

2018 Outlook

Monetary policy globally is undergoing significant adjustment. The U.S. Federal Reserve is reducing the size of its balance sheet thereby removing excess liquidity. The European Central Bank has announced a tapering of their quantitative easing program. The Bank of Japan is likely to shift the parameters of their yield curve management process; reducing market support and balance sheet expansion further. The Bank of Canada, U.S. Federal Reserve and Bank of England raised interest rates in 2017. Given that the current synchronized improvement in global growth is reducing unutilized capacity, unemployment across the developed economies is declining, output gaps are closing and financial conditions remain easy, we expect central bank policy accommodation to be removed further. We want to be clear, we are not aggressively bearish on interest rates. However, we do believe interest rates will prudently be adjusted higher. Therefore, we will have a bias to remain short duration relative to our benchmark across all markets. Given that rate volatility is likely to increase, duration management will be key to outperformance in 2018. Trading interest rate momentum aggressively will likely result in reasonable alpha generation. Yield curve and geographic positioning will also aid in generating excess returns.

In the first quarter of 2018, ten year U.S. Treasury yields are expected to trade in a 2.25% to 2.55% range. We believe the range for the year will be 2.10% to 2.70%. If ten year U.S. Treasury yields were to approach 3.0%, we would expect to get aggressively long. The equivalent ranges for ten year Canadian government bonds are forecasted to be 1.95% to 2.25%. We believe the range will be 1.65% to 2.35%. We would consider a 2.50% level on ten year Canadian government bonds as an aggressive buying opportunity.

Investment grade credit has contributed significantly to excess returns, as credit spreads tightened 20-30 basis points in each of the past two years. Our base case for credit spreads is for them to remain flat or to tighten 10 basis points in 2018. We also expect that any tightening in credit spreads to be front loaded. This base case, to which we assign a 40% probability, is based on current valuations which we believe are expensive relative to credit metrics, and nominal if there are any improvement in leverage metrics. Our best case of credit (15% probability) is for a 10 to 15 basis point improvement in credit spreads. Virtually everything for credit would have to go right for this scenario to transpire, and we think this is a high hurdle. By everything going right we mean: equities higher, corporate earnings solid, economic growth stable to stronger, continued foreign demand, large inflows into bond funds, lower new issue supply and a gradual rise in interest rates. Our worst case for credit spreads (45% probability) is for a 15 to 25 basis point widening in credit spreads. We would see this level of widening to be a good buying opportunity, given that we are not forecasting a recession in the next 12-18 months.

Bottom line, with spreads still trading in range, we will continue to take the carry and trade credit more actively to generate alpha.

As noted above, with investment grade corporate credit unlikely to generate a lot of excess return, we believe duration management will be the key to this forecast.

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Paul Sandhu has 29 years of domestic and international fixed income experience. Prior to joining Marret, Paul was responsible for the global distribution of Canadian fixed income and money market products at BMO Capital Markets. Through offices in Toronto, Montreal, Vancouver, New York, London and Hong Kong, Paul was directly responsible for advising the world's largest fixed income asset managers on portfolio strategy, asset mix, security selection and alpha/beta generation.

Paul's career also includes positions with Goldman Sachs and Citibank in Europe, the United States and Canada.

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