

## **Fundamental/Technical Outlook**

Global growth is slowing, inflation is stable, and central banks have turned cautious – creating a positive backdrop for interest rates. Interest rate markets are now pricing almost a full cut in the Federal Funds rate by the end of 2020. Risk markets are also having a very strong start to the year, with investors focused on a “patient” U.S. Federal Reserve, more attractive earnings valuations, and earnings growth that’s coming in better than originally feared. The question is: which market can continue to rally, rates or risk? Rates shouldn’t be able to rally from here unless growth slows further, especially given the supply overhang of the deficit. But risk shouldn’t be able to rally further, if indeed global growth is slowing.

Simplistically, the world has two engines of growth: the U.S. and China. The first engine, China, has been slowing mostly because of past macroprudential policy tightening with the added catalyst of a hostile U.S. Administration. Over the past year, the Chinese policymakers have pivoted to targeted easing, but the scale of the policy measures, thus far, are still relatively modest. The second engine, the U.S., will experience a fading fiscal impulse in 2019, at the same time as past Federal Reserve tightening measures will be increasingly felt. Unlike in China, the Federal Reserve has only paused not pivoted. Our view is that the Federal Reserve will take their cue from rate markets, not the other way around; i.e., if growth is better and rate markets begin to price in hikes, the Fed will turn hawkish and if the opposite happens, the Fed will turn dovish.

In addition to the dynamics of global growth and policy, the balance of supply and demand in fixed income markets will be an important factor to watch over the course of the year. We know there will be a large amount of supply in the U.S. Treasury market and expect significant issuance in the investment grade bond market. This supply will be coming at a time when the Federal Reserve balance sheet is still shrinking in size, but we’ll save that discussion for another month.

The overall economic and policy environment is supportive of benchmark duration. However, the expectations priced into rates is, in our view, inconsistent with the pricing of risk markets. We expect risk markets to remain elevated for a period and interest rate markets to stabilize at higher yields until signs of further pressure on global growth are clearer. We are tactically underweight duration and will look to get closer to benchmark duration in the 2.85% to 2.95% area on 10-year U.S. Treasuries.

## **Fund Positioning**

*Overall duration:* Underweight

*Cross-currency:* Overweight the U.S. vs Canada

*Maturity:* Overweight 10-yr vs front-end and 30-yr

## **Key Transactions**

- Modestly increased duration, primarily with Government of Canada 10-yr bonds.

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