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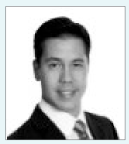
Foresights from Foresters Asset Management.

The new sweet spot for fixed income?

Portfolio Managers

Imran Chaudhry, CFA
VP & Senior Portfolio Manager



Kon-Yu Lau, CFA
VP & Senior Portfolio Manager

Foresters Financial

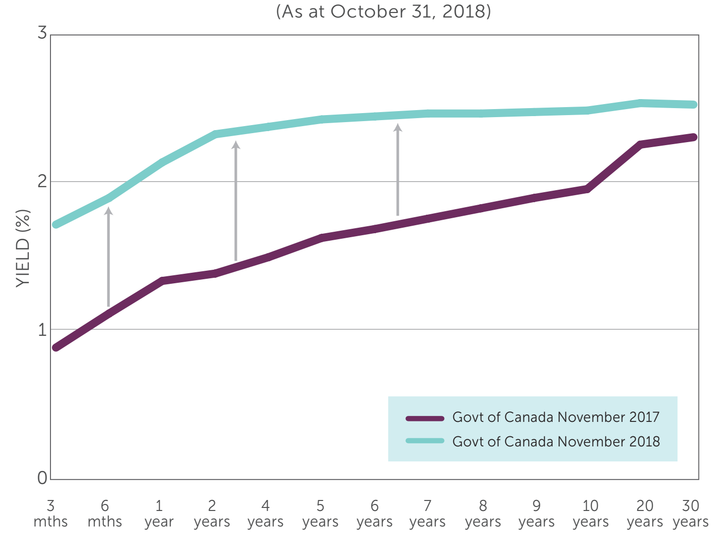
Summary

- Rising interest rates suggest a turn away from fixed income, and industry flows support this.
- Flattening and inverted yield curve usually means a recession is looming, but is it?
- For a long time, the market has championed TINA ("there is no alternative") rationale for buying stocks. Though flows into fixed income are negative YTD, in the past few months, money has started pouring into short term fixed income funds*. Is this the new "Sweet Spot" and safe haven in today's market environment?

Looking at today's bond market, an interesting dynamic is at work. First, interest rates have moved notably higher in the past year for the Canadian government yield curve (see Exhibit 1). During this time, 10-year Canadian government bond yields have increased roughly 45 basis points (bps). Secondly, in 2018, the Canadian yield curve has flattened as interest rates have increased at the front end. Over the same time period, two year bond yields have increased by 65 bps and 5 year bonds by 57 bps.

Why should a flatter yield curve matter? Typically, it is an indicator of an upcoming recession. Given that many pundits consider the U.S. and Canadian economies to be closer to the end of its current economic cycle, the flattening yield curve is garnering quite a bit of attention. However, long-term interest rates have remained higher than short-term interest rates. Recessions generally are associated with an inverted yield curve when the Bank of Canada (BoC) has raised short-term rates above the level of long-term rates.

Exhibit 1 - Snapshot of Canadian Yields
(As at October 31, 2018)



Source: Government yields: FactSet, Corporate yields: Bloomberg.

*Source: Investments Funds Institute of Canada.

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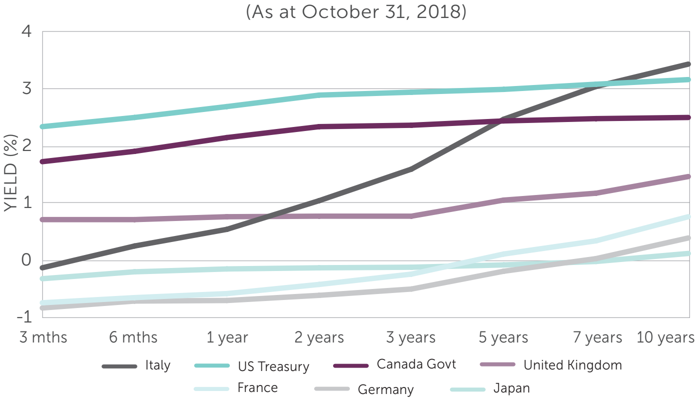
This leads us to another question: why have longer-term rates, which have edged up, not increased as much as many industry analysts expected? Although, south of the border, the 10-year U.S. Treasury has passed the "magical" 3% level, it still appears to be stuck around that threshold. In Canada, the level is less pronounced, but still the ceiling remains. So why is there a level of resistance being encountered? We think there are several reasons. The path of long term rates is dictated by growth outlooks, whereas short term rates are dictated by central banks' monetary policies. During the year, despite central banks' willingness to raise rates, growth concerns continue to weigh on longer rates, due to U.S. and China trade and tariff rhetoric. Considerable demand for long-term assets with yield, such as corporate bonds and municipals, from the retiring Baby Boomer generation, continues to be a factor in this market. Pension plans, given their extended liability needs, are traditionally buyers along the long-end of the yield curve. Also, U.S. & Canadian rates remain significantly higher than foreign rates, which have attracted demand from overseas investors. Each of these factors can exert downward pressure on bond yields in both Canada and the U.S. The exception to this is Italy, where rates have risen, due to concerns that it's high debt may be unserviceable.

What's happening overseas?

Turning our attention to the global picture, Exhibit 2 illustrates recent yield curves for the G-7 countries**. U.S. & Canada rates are clearly high, relative to the rest of the developed world (with the exception of Italy), and while this relationship has been true for some time, the spread is quite evident at the moment. Although the general market consensus earlier this year expected a number of these countries to raise rates, they have largely taken a pause in hiking them. Global growth concerns and the strengthening U.S. dollar have been the causes for this divergence in global central banks' monetary paths.

Exhibit 2 - G-7 Yield Curve Shows North America as an Outlier
(As at October 31, 2018)



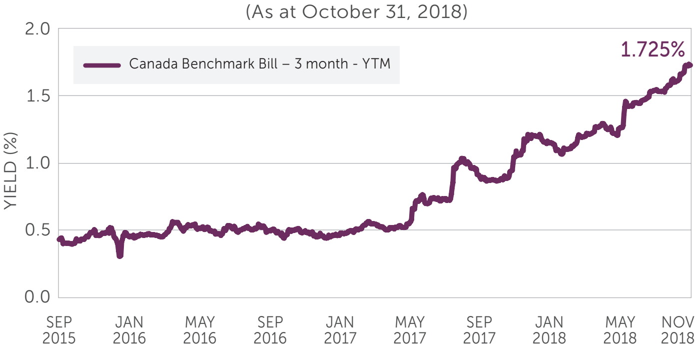
Source: Bloomberg, November 2018.

What does it all mean for investors?

Interest rates along the shorter end of the curve (see Exhibit 3), which are extremely responsive to the BoC actions, have increased sharply, as the BoC has entered a tightening phase in its monetary policy cycle. This segment of the market has become fairly attractive for investors who can now, perhaps surprisingly, get a solid return on relatively low-risk investments for the first time, in a long time. As a result, cash flows into short-term bond funds have risen, with fairly limited duration exposure providing an additional incentive. There now appears to be an alternative to buying long-term (and potentially riskier) bonds or even stocks, while simultaneously offering a lesser risk profile.

For a long time, the market supported the TINA ("there is no alternative") rationale for buying stocks, but now, there is another option to consider and investors seem to be embracing it. With a more cautious view of the stock market, combined with higher interest rates in the shorter part of the yield curve, some investors may have found a sweet spot in fixed income. Short duration fixed income reduces ones sensitivity to interest rate fluctuations. Furthermore, the additional yield in corporate bonds serves as an excellent "buffer" against a price drop, due to rising interest rates.

Exhibit 3 - Canada Benchmark Bill - 3 Month - YTM (%)
(As at October 31, 2018)



Source: FactSet, November 5th 2018

**The Organization for Economic Cooperation and Development (OECD) defines the G7 as the major seven countries comprising: Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

Foresters Asset Management ("FAM") – imaxx™ mutual Funds at a glance

FAM has core expertise in managing Canadian fixed income, especially corporate bonds. FAM's founding principles:

- Overweight non-government bonds vs. the benchmark index (typically 3x market weight)
- Canadian investment grade universe (no high yield)
- Duration-neutral to underlying benchmark index
- 100% Canadian dollar

	imaxx Canadian Short Term Bond Fund	imaxx Canadian Bond Fund
Yield	3.19%	3.58%
Benchmark Yield	2.71%	3.02%
Duration	2.69 Years	7.28 Years
Corporate Bond Weight	81.4%	77.6%
BBB Weight	41.3%	33.6%

Data as at October 31, 2018.

For further information visit forestersassetmanagement.com/imaxxwealth.com

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