Foresights from Foresters Asset Management Inc.

Fixed Income Outlook

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Kon-Yu Lau is a fixed-income portfolio manager, responsible for co-managing over $8 billion in fixed-income assets.

Kon-Yu joined Foresters Asset Management (FAM) as a fixed-income analyst in 2002. Before joining FAM, he was an investment accountant valuations specialist at ivari. Kon-Yu graduated from McGill University with a BCom in finance and international business in 1997. He received his Chartered Financial Analyst (CFA) designation in 2006 and has also earned the Financial Risk Management (FRM) designation in 2003.

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Overview:

- 2017 was a year of interest rate hikes and euphoria, as markets anticipated tax reform and reduced legislation. Credit performed well and spreads have continued to tighten.
- All key FTSE TMX bond indices remain in positive territory, with long-term credit outperforming short-term instruments.
- We see credit and spreads range-bound in the first half of 2018, but both may see some give back in the second half of the year, depending on the Fed policy.
- There is the potential for the Fed to raise rates 3-4 times over the course of the year, depending on the performance of the economy. 4 hikes may be a mistake and cause the economy to rollover. It could also cause the yield curve to flatten or even invert.
- Risks to our outlook include NAFTA, a trade war, and U.S. inflation undershooting.
- We see the U.S. 10-year ending 2018 at 3% and the Fed Funds Rate at 2.00%. We expect the yield curve to flatten but not invert.

2017: A Year in Review

Broadly speaking, it's been a decent year for fixed income investors. Short term bonds have lagged longer-dated issues given central bank rate hikes. Yet all major FTSE TMX Bond Indices turned in positive performances for 2017. The euphoria in the markets, which took hold after Trump's election last November, has helped credit markets, with spreads continuing to tighten.

2017 Bond Returns	Year-To-Date (%)
FTSE TMX Corporate Bond Index	3.38%
FTSE TMX Canada Universe Bond Index	2.52%
FTSE Short Term Corporate Index	1.03%
FTSE TMX Short Term Bond Index	0.08%

Source: PC Bond

2017 was the year in which the Fed (and to a lesser degree, the Bank of Canada) meaningfully embarked on a course of raising short term interest rates. Defying some skepticism, the Fed managed to hike rates 3 times over the course of the year. It also signalled, and then started, the gradual winding down of its crisis-era quantitative easing measures. This process has, as of yet, not alarmed bond investors.

2018: FAM's Fearless Fixed Income Predictions!

2017 is in the history books. So, what does 2018 have in store for fixed income investors? Anticlimactic as this may sound, we actually think the trends of the past year will continue. We believe that short term rates will rise some more, but the long end won't keep pace, resulting in a further flattening of the yield curve.

The economic backdrop is set for more rate hikes by central banks, particularly the Fed. U.S. GDP is exceeding expectations, and business capex and residential investment growth are both strong. So too is consumer spending. Add to that hurricane rebuilding in Florida and Texas, and Q4's GDP number ought to be impressive. As it stands, 2018 GDP is projected at 2.4%. But that's before the effects of the significant tax reform, which was signed into law in December. That should add another 0.6%, bringing estimated growth for the year to 3.0%.

There are two other good reasons why the Fed will lean hawkish in 2018. For one thing, it desires a certain amount of 'dry powder' for the next recession. In other words, so as to avoid having to resort to unconventional measures to combat a garden-variety contraction, the Fed will want to be able to significantly lower its overnight rate. That requires getting it to a high enough level before a slowdown hits. In addition, one gauge tracked by the Fed has inflation running at 2.5-3.5% next year, a rate which is too hot for the central bank's comfort and further supportive of continued rate hikes.

We see the Fed raising rates 3-4 times in the coming year. And we think if they do 4 hikes, that could constitute a policy misstep, ultimately risking a 2019 recession. The risk of an eventual recession aside, 3-4 hikes should cause the yield curve to flatten even further. Having said that, with most of the focus on the Fed's overnight rate, we do see the potential for its balance sheet contraction to cause some issues for bond markets. So far, the market has not been too phased by the unwinding of QE, but there's no guarantee this complacency will be indefinite.

Risks to the Outlook

There are a few key risks to our outlook for fixed income as we enter 2018. First, inflation may undershoot expectations. Headline inflation is running at 2.00% but core PCE, a key measure watched by the Fed, remains at 1.45%. This is off the August lows but still considerably below the Fed's target of 2.00%. Should inflation keep coming in below their desired rate, the Fed may back off its current hawkish stance.

Second, trade protectionism may pose a threat to the economy (notably Canada's) in 2018. On the issue of NAFTA, it's clear the U.S. wants to renegotiate. If it doesn't get a better deal, it may announce a withdrawal from the accord. Such a withdrawal would not be immediate given that Congress would need to vote. Yet even an announcement of termination could cause even more economic uncertainty in Canada among exporters, and reduce business investment. NAFTA aside, we can't rule out the possibility of a U.S./China trade war. While unlikely to happen, it could shave 0.5% off of U.S. growth and 1% off Chinese GDP. The OECD has said that should a trade war extend to Europe, all three regions could see a 2-3% hit to GDP.

Finally, geopolitical risks obviously remain. North Korea can be expected to stay in headlines, especially as the Olympics nears. The Middle East may yet upset markets (and lead to higher oil prices). And though Brexit should go reasonably smoothly, it may yet cause an economic disturbance.

Here at Home: The Outlook for Canada

We think Canadian GDP will grow 2-2.2% for 2018, which is somewhat below our estimate for the U.S. In short, there are three factors which should cause the Canadian economy to underperform: housing, wages and digital disruption. A slowing housing market should cause residential construction to slow. Wage growth at 1.7% is a problem for consumer spending. Together with changes in spending patterns related to services, such as Amazon and Uber, this means a reasonable amount of slack in the economy. A potential fourth issue is NAFTA uncertainty, which may lead businesses to hold off on making investments. For all these reasons, we only see the Bank of Canada raising rates 2 times in 2018, a much less hawkish pace than the Fed.

Issuance: Supply and Demand Imbalance

Like all other markets, fixed income is affected by supply and demand. In this regard, it's worth pointing out the tailwinds for the Canadian bond market as 2018 approaches. Of note, the total value of bonds maturing is steadily decreasing, which is curtailing supply. In 2016, $88 billion of securities matured. In 2017, the figure was $77 billion. For 2018, it's estimated that only $73 billion of fixed income product will mature. On the demand side, we expect investors to rotate out of equities and into bonds as the yield curve flattens. These factors do not necessarily mean 2018 will be a great year for fixed income, but on the margin they should be supportive.

FAM Portfolio Positioning

As we look to the new year, we continue to look for value in the fixed income market. We have taken three steps given the current economic and market backdrop:

- Removed exogenous risks – namely those correlated tightly to the Canadian housing market.
- Upgraded the quality of the portfolio, and willing to give up small amounts of yield to hold better quality assets.
- Prepared ourselves to take advantage of yield curve anomalies / inefficiencies as it flattens.

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