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Third Quarter 2018

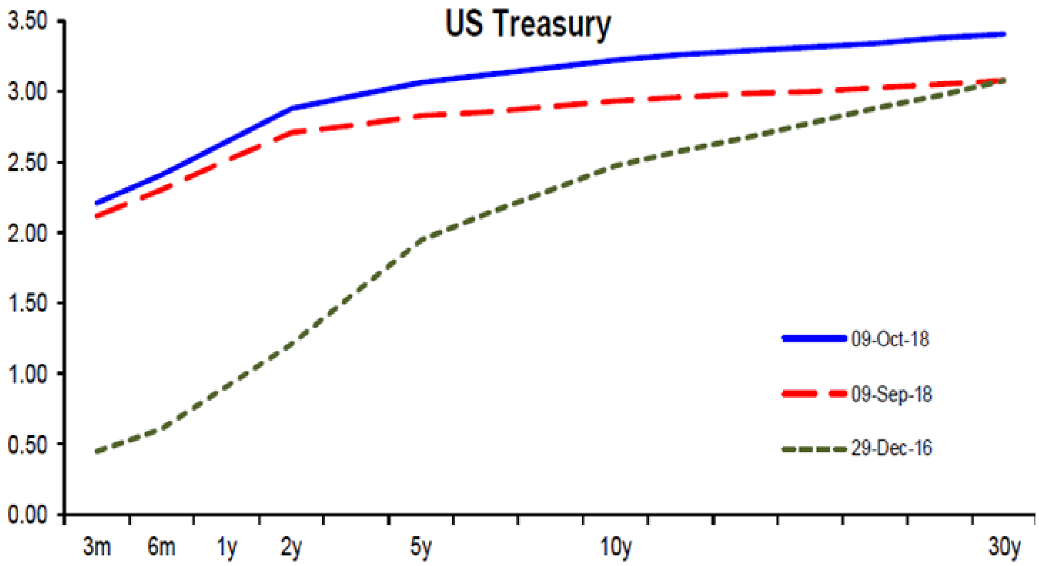
After years of waiting for interest rates to move to up to more normal levels, and of longing for decent returns from safe investments, bond yields in the U.S. have risen to a 7 year high. Careful what you wish for.

The 5 year U.S. Treasury bond that at the end of 2016 yielded 1.97% now yields 3.07%. The 5 year Canada yielded 1.12% at the end of 2016 and now yields more than twice as much, 2.48%. When it comes to the stock market, the U.S. Federal Reserve Bank plays the tune. In the ten years since the financial crisis, central bank engineered ultra-low interest rates made stocks seem like the only game in town.

This year, both the Bank of Canada and the Federal Reserve have raised short term rates several times already and are expected to do so several more times next year. The Bloomberg Forecast is for the Fed funds rate to move up from 2.25% in the third quarter of 2018 to 3.10% by the end of next year. The Bank of Canada overnight rate was 1.50% in Q3 2018 and is expected to be 2.45% in the fourth quarter of 2019.

The U.S. yield curve pictured below shows the dramatic increase in 3 month rates and the levelling of interest rates for terms between 5 and 30 years. The flatish yield curve itself is a forecast of moderating economic growth rates expected next year.

US TREASURY YIELD CURVE



Graph from RBC's Morning Insight

Rising interest rates have had significant repercussions for the fixed income in our portfolios. Most immediately, higher yields translate into lower bond prices. For some time we have been concentrated in short term bonds and deposits largely coming due regularly over the next 5 years. As they mature and get reinvested we will start to get some benefit from higher yields.

For stock prices, rising interest rates don't matter, until they do. Historically, rising short term rates have not at first been necessarily bad for stocks, as they reflected a strong economy. J.P. Morgan reports that in the past the tipping point has been about 5%. When interest rates were below 5%, rising rates didn't seem to be bad for stocks, but, when rates were above 5%, rising rates were usually associated with falling stocks. Today though, may be different. Years of unnaturally low interest rates have led to high debt levels. Therefore, the inflection point at which higher rates become a headwind for equities might be lower now.

The industry groups like Telecom Services, Utilities, Pipelines and Consumer Staples, that are sought for their substantial and reliable dividends, are most directly affected by the competition for investment dollars that higher interest rates represent. All four groups have had negative returns this year.

Weakness in the interest sensitive groups is part of the explanation of why the Canadian stock market has so dramatically underperformed the U.S. S&P 500 Index. Although I might point out

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that many of the world's stock markets have done even worse this year. Emerging Markets, many of which have large U.S. dollar debts, have been especially weak. The bigger explanation for the relative outperformance of the U.S. stock market so far this year must be the preponderance of the FAANG (Facebook, Apple, Amazon, Netflix, Google) stocks in the S&P 500 and, U.S. tax cuts.

This is the time of the year when bargains can appear in the stock market. Many of us get a bit gloomy as the days get shorter, me not excluded. Nervous investors can be quick to sell winners. Also, the added pressure of tax loss selling can create unwarranted declines in stocks that have performed poorly. We'll keep an eye out for good buys this fall. There seems so much for investors to worry about. Then again, there always does. It is hard to know how much of the recent stock market selloff should be attributed to rising rates or, to trade wars. The extent to which corporate profits and the economy are being crimped by the tariffs should become clearer in the next few weeks as companies start to report their third quarter results. We will try to keep calm and carry on rebalancing consistently.

Happy Thanksgiving and thanks for reading.

Sincerely,

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Portfolio Manager, Vice-President
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