QV Update

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A Change in Leadership

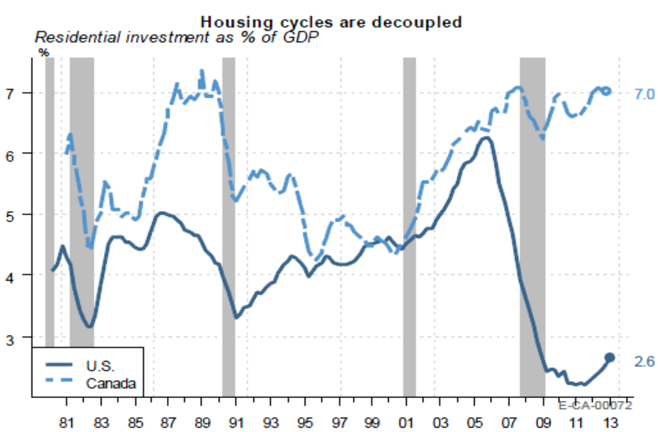
Governor Mark Carney presided over his last Bank of Canada monetary policy meeting this week before taking up his new post as Governor of the Bank of England. His final communiqué did not contain any material policy changes or any changes to their macro view. Canada's overnight rate remains at 1.0%, inflation remains subdued, and global economic activity is expected to grow "modestly" this year. The language regarding the future direction of interest rates remains the same: *"...after a period of time, some modest withdrawal of monetary stimulus will likely be required consistent with achieving the 2% inflation target."* Translation: the next rate move is higher, we are just not sure when.

If the bond market holds true to its predictive nature, we may not have to wait too long for borrowing rates to rise. Longer-term interest rates are already rising. This week, the 10-year Canada benchmark bond rose above 2.0%, its highest level since April, 2012. The move in US Treasury bonds was even greater, as the 10-year benchmark bond yield rose by 0.4% to 2.1% in May alone.

The US Central Bank's disclosures about the potential slowdown to their latest bond purchasing programme, combined with improved US consumer confidence and housing numbers, are some of the reasons for the recent upward movement in bond yields. Investors are pushing bond yields higher in anticipation of a sustained economic recovery.

US/Canada Decoupling Continues

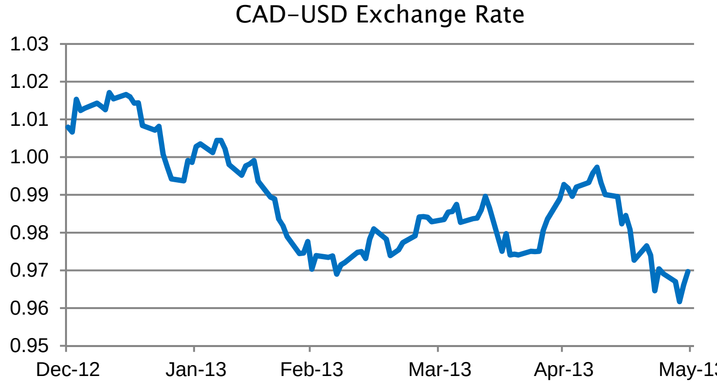
While the US economy improves, the outlook for the Canadian economy remains weaker in comparison. Tighter mortgage restrictions are having the desired effect to slow down the accumulation of household debt, but at the expense of limiting the housing sector's contribution to our economy. As suggested by Pavilion Global Markets in the chart below, the US economy is poised to benefit from an increase in residential investment, while Canada retreats back to more normalised levels.



Source: Pavilion Global Markets (BEA, StatsCan data via Bloomberg)
Shaded area= U.S. recessions

Generating positive growth in Canada will be dependent upon an increase in non-residential investment and an improvement in exports. Low cost of capital and accommodative lending conditions should continue to support business investment in Canada.

However, for exports to improve, the Canadian dollar must weaken further.



Source: Bloomberg

The depreciation in the Canadian dollar this year (and illustrated in the chart above) has been gradual and in line with the weakening in commodity prices. As China's economy slows, and the US becomes less reliant on oil imports due to their own energy boom, the Canadian dollar could weaken further. As our economy retreats from a housing and commodity boom, a weaker currency should support our exporting companies.

As Canada's Economy Slows, Why Should Bond Yields Rise?

The change of guard at the Bank of Canada may not bring an immediate change to policy rates. With inflation hovering below 1%, there is no immediate need for the Bank's policy rate to rise. However, improvement in the economy of our largest trading partner may begin to restore some balance back to the Canadian economy that has grown dependent on the household sector for growth. This rebalancing of economic leadership was evident in the first quarter of 2013 as exports propelled our growth rate to 2.5%. Further, a weaker Canadian dollar not only benefits our exports, but also may reverse the disinflation trend as imports become more expensive. If the trend continues, we expect higher bond yields may be in store to compensate for rising inflation risks. A reversal of the "safe haven" trade that brought fund flows into Canada following a wave of sovereign credit downgrades may also put pressure on bond prices. A depreciating Canadian dollar is not a "haven" for international bond investors.

Our Strategy

Our move to shorten the term to maturity of our bonds should limit price declines if yields were to continue to move higher. In our Balanced Fund, we maintain our bias in favour of equities. Within our equity portfolios, we began trimming our more interest sensitive holdings in the telecom and utility sectors earlier in the year following strong price gains and less attractive valuations. We expect insurance companies to benefit if bond yields continue their upward trajectory. Banks may also see an offsetting benefit to declining mortgage volumes as a steeper yield curve should improve margins as borrowing rates rise. We continue to maintain a strong position in banks and insurers in our equity portfolios.