CUMBERLAND

Private Wealth

FIXED INCOME YEAR END REVIEW

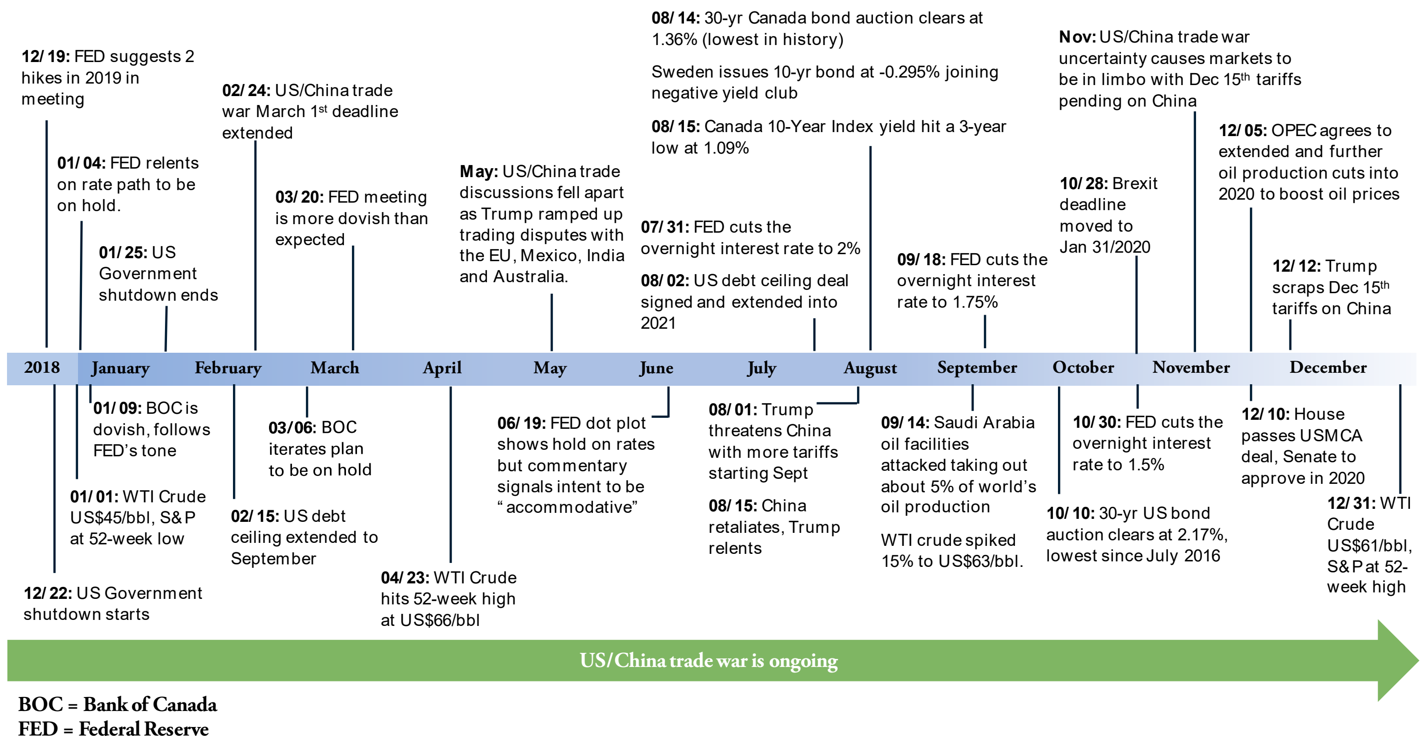
2019 - The Year of Intention

Google search defines intention as "an aim or plan" and (in medicine) "the healing process of a wound."

The latter is rather befitting given how 2018 ended: anyone who participated in the markets in 2018 was pretty badly beaten up that December. Almost every asset class lost money in 2018. Healing from those 2018 battle wounds was going to take time as everyone knows that even with the most determined patients, there could be challenges along the way. Thankfully, we saw progress in 2019.

Below is a timeline of some major events in the year. It is quite crammed but that's because there was so much impact on the bond markets from these events.

Exhibit 1: Timeline of 2019



BOC = Bank of Canada
FED = Federal Reserve

There was a lot of blame by the end of 2018 for what caused these injuries: Trump, China, Trump, Federal Reserve, Trump, oil. The list goes on and on but let's focus on those. It was clear no one would sit back in 2019 and not put up a fight and persevere.

So let's check up on some of these patients and the impact on Canadian bond investors.

Patient #1 -US & China Trade War

History: The first tariffs between the US and China kicked in back on July 6, 2018 and have since then escalated throughout 2019. With Trump leading the charge on more tariffs throughout the year, we started to see Trump relent to some of his threats (first in August, then again in December). Tariffs are still in place generally but discussions are continuing.

Status: Day to day - there have been many ups and downs; however, more recently, the momentum is directionally headed towards a resolution, the timing of the recovery is still to be determined.

Impact: With the tariffs in place, some companies have had to re-route their goods via other avenues, seen less demand in general for their products because of increased prices, and remained on the sidelines with their long-term investment plans. In addition, with the continued negative headlines instilling fears of an oncoming recession, consumers have erred more prudent with their spending. In Canada, retail sales have been negative to flat at best year over year. If spending slows, GDP will slow, which will likely cause a recession. As you can see, the symptom is now the cause? Either way, if GDP slows, then there could be the need for overnight interest rate cuts to stimulate economic growth. In 2019, the Bank of Canada did not cut short-term interest rates.

Patient #2 - Federal Reserve (FED)

History: The Federal Reserve is an independent board, operating separately from the US government. Jerome Powell's role this year has been tough - not only is his job already a challenge in the normal course: to anticipate the unanticipated of the economy, but this year in particular, there has been the added issue of escalating tariffs causing new obstacles for his analysis. In addition, he has had to deal with public abuse and pressures from Trump. Amongst the blurred lines of government interference and slowing economy, some question the three interest rate cuts during 2019 that have brought the overnight interest rate to 1.5%. It is anticipated that the FED will be on hold for most of 2020 with a potential further rate cut in December.

Status: This patient was clearly under duress in the first half of 2019, but seems to have come around and is recovering slowly.

Impact: Canada's overnight interest rate at 1.75% is now the highest among the world's major economies. While Canada's largest trading partner is the US, the strong Canadian dollar is a major factor to ensuring exports stay competitive. The Bank of Canada is currently on hold, but the bias of a slowing economy (because of potentially slowing exports) could see the Bank cut interest rates in the future.

Patient #3 - Oil

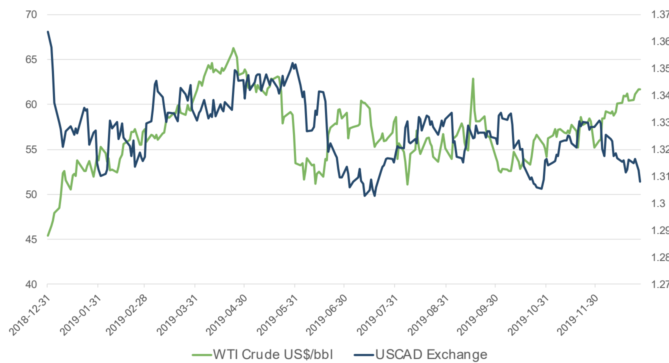
History: There are two primary issues that Canada focuses on with respect to oil:

1) the price of West Texas Intermediate (WTI) crude as that is the benchmark in oil pricing; and
2) the differential between Western Canada Select (WCS) and WTI.

Energy accounts for about 11% of Canada's GDP (direct and indirect), so the swing in oil prices does have an impact on Canada's economy. It is also closely tied to the currency (ie. the Canadian to US dollar exchange rate), whether we like to believe in Canada's "petrocurrency" or not. Exhibit 2 shows the correlation of the higher the price of WTI and the depreciation of the US dollar vs. Canadian (ie. the Canadian dollar is appreciating). WTI crude started the year at US$45/barrel (bbl) and has since then risen to $61/bbl by end year. There were definitely ups and down in the price caused by: an attack of oil tankers, the US threatening to sanction countries in buying oil from Iran, the terror attacks on the Saudi Arabia oil facilities that took out 5% of global production, and OPEC continuing production cuts into mid 2020.

WCS is produced in Alberta and blended before it is exported from Canada to the US. The differential between WCS and WTI crude widened out to a discount of US$50/bbl in October 2018. This gap is important given that this would mean forgone revenues for the Canadian government. On average since 2008, the gap has been at a discount of US$17/

Exhibit 2: WTI Crude vs. US/CAD Exchange Rate



Source: Bloomberg

bbl. The reason for the steeper discount last year was mainly due to the increased supply of oil but lack of transportation capacity (pipeline and rail) and restricted market access. The Alberta government intervened in early December 2018 to announce mandatory oil production curtailments for the first 6 months of 2019, and then by summer, it extended those production cuts into 2020.

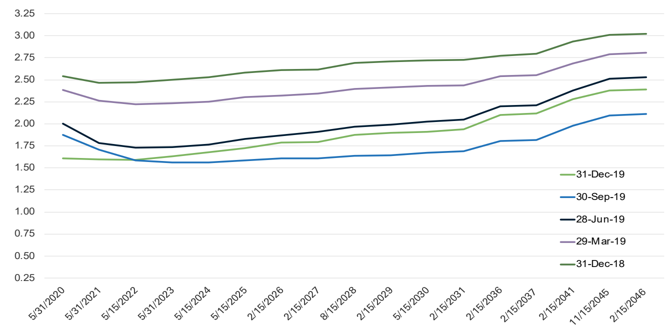
Status: This patient is under critical care with both global and local aids helping. Continuous observation and monitoring will be required to maintain the price of oil in a certain range that the world requires to balance its respective local economies.

Impact: If oil prices are stable (ie. at least US$55/bbl), this helps the Canadian economy but also stabilizes our currency. For Canadian bond investors, a stable or improving oil price signals an improving economy, but volatility in oil prices causes more uncertainty for the Canadian economy and therefore a potential for monetary policy (ie. interest rates cuts) to intervene and provide a buffer. Luckily for us, 2019 was an improving oil environment.

Quarter & Year Review

During the quarter, the Fed cut interest rates once for the 3rd and final time in 2019 to bring the overnight interest rate to 1.5%. The Fed is expected to be on hold for most of 2020 (with the market expecting a cut in December). Interest rates for the quarter moved 26 basis points (bps) lower in terms of the 6-month rates but actually moved anywhere between 6bps to 27bps higher in the 1 to 30 year bonds. For the year, interest rates moved 63bps to 93bps lower across the curve.

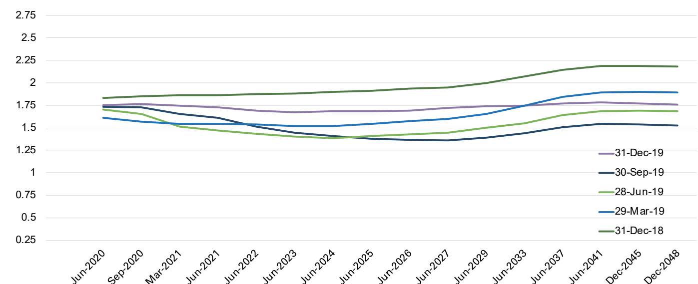
Exhibit 3: US Yield Curve



Source: Bloomberg

On the Canadian side, the Bank of Canada held interest rates firm for the quarter and the year. With the improvement in US/China trade relations and oil prices remaining relatively strong, the yield curve was up anywhere between 7bps to 31bps across the curve for the quarter. The volatility of the 10 year Government of Canada bond moved from peak to trough 37% during the quarter (higher than in Q3 at 32% and Q2 at 21%). For the year, rates moved lower anywhere between 8bps to 42bps across the curve while the 10 year Government of Canada bond moved 46% from peak to trough.

Exhibit 4: Canada Yield Curve



Source: Bloomberg

Canadian investment grade corporate spreads were tighter anywhere between 7bps to 15bps across the curve and rating categories during the quarter. On the year, spreads were tighter anywhere between 25bps to 58bps across the curve and rating categories.

Returns for various fixed income asset classes are shown in the table below.

Asset class returns	Q4/19	Q4/18	2019	2018
Bond Universe Index	-0.85%	1.76%	6.87%	1.41%
Corporate Bond Index	0.06%	0.86%	8.05%	1.1%
High Yield Canadian Index	1.37%	-1.68%	8.48%	2.15%
S&P/TSX Preferred Index	4.09%	-11.85%	1.99%	-12.21%

During the quarter, the best performing segment was short corporate bonds (+52bps), while long government bonds underperformed the most (-345bps). For the year, long corporate bonds (+1,441bps) were the best performing segment, while short government bonds (+214bps) underperformed the most.

Outlook: Welcoming the New Decade

With the continued issues lingering (US/China trade wars, FED moves or lack of moves, and oil prices), we will use our existing knowledge and also what we learned from our 2019 experiences for 2020.

While the yield curve is steeper, it is still not steep enough. Q4 has shown that negative returns in bonds are possible given the impeding risks where fleeing to safety and the flattening of the yield curve appears to be an overreaction if global issues gets resolved. The 30 year government of Canada bonds ended 2019 at 1.76%, pretty much flat to the overnight interest rate at 1.75%.

Due to the daily volatility of these markets, we continue to be patient and opportunistic as we add to existing and new positions into our funds. At the end of Q4, there were 89% of the bonds in the Canadian Bond Universe trading above par (down from 92% at the end of Q3 and 95% at the end of Q2). Indeed, it was prudent to be cautious in 2019.

As with every new year, bond markets typically ramp up with issuance or financings in Q1. We expect it to be busy – but we will continue to stay disciplined and focused on preserving capital and managing the risk for our unitholders.

Take Care,
Diane Pang

Lead Manager,
Cumberland Fixed Income*
January 2, 2020

*Cumberland refers to Cumberland Private Wealth Management Inc. (CPWM) and Cumberland Investment Counsel Inc. (CIC). CIC acts as sub-advisor to certain CPWM investment mandates including the CPWM Fixed Income mandate with Diane Pang as its lead Portfolio Manager. Diane Pang is a Portfolio Manager at CIC.

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