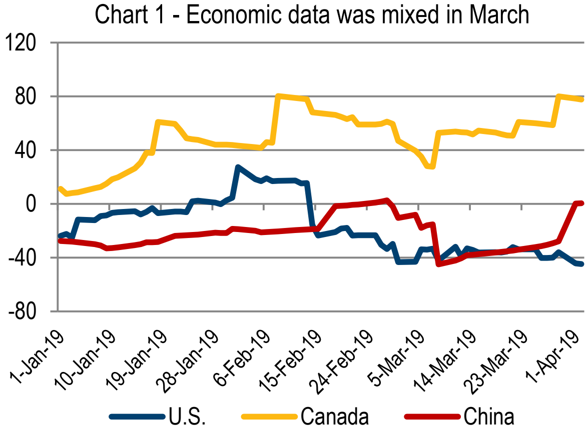
Tactical Asset Allocation (April Update) – Yield Curve Musings

Economic developments during the month of March were mixed. While Canada seems to be gradually rebounding and China started to show signs of renewed strength towards the end of the month, the already weak Economic Surprise Index failed to improve in the U.S. (chart 1). Combined to the fact that the U.S.-China negotiations on trade are still ongoing and creating uncertainty, such tepid economic news led both the Bank of Canada and the Federal Reserve (Fed) to strongly re-affirm their "wait-and-see" approach. Their statements confirmed market expectations that no rate hikes are on the table until the end of 2019 and possibly beyond.[1] The Fed will also stop selling assets from its balance sheet by next October.

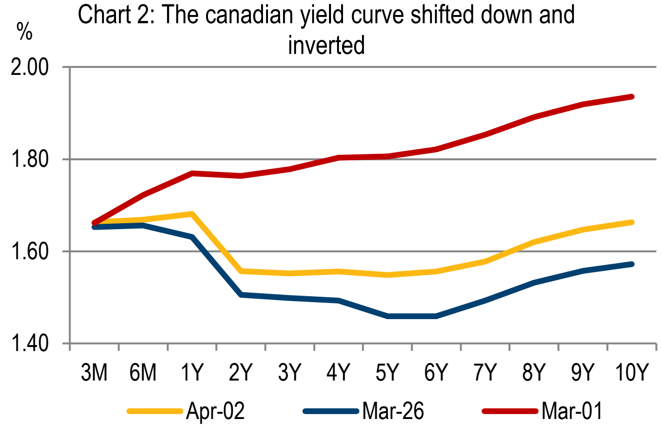
As a reaction to both the uncertain global economic outlook as well as increasingly dovish central banks, the yield curve in both countries shifted down, flattened dramatically, and even briefly inverted in the key 10Y-3M segment (chart 2) towards the end of March. Consequently, bond indices over-performed stocks in March. Our benchmark model comprised of 70% Canadian government bonds and 30% corporate paper increased 2.2% while the S&P 500 and S&P TSX indices gained 1.8% and 0.6%, respectively.

Chart 1 - Economic data was mixed in March



Note: Daily index.
Sources: Citi Economic Surprise Index/Citigroup/Bloomberg Finance.

Chart 2: The canadian yield curve shifted down and inverted



Note: Data is interpolated.
Sources: Bloomberg Finance L.P. and LBS Econ. Res. and Strategy.

About an inverted yield curve

As we argue below, we are of the view that the yield curve is bound to steepen going into the second quarter of 2019. In the current environment of heightened volatility, other brief periods of yield curve inversions in the 10Y-3M and 10Y-2Y segments could occur over the next few months. However, while we don't dispute that the inverted yield curve has been a reliable leading indicator of recession in the past, at least in the U.S., some observations might help investors to better gauge the implications of the recent inversion episode for economic growth.

[1] The Bank of Canada wrote in its March statement that it "will take time to gauge the persistence of below-potential growth and the implications for the inflation outlook", removing references to the need for rates to "rise over time". In the U.S., FOMC members lowered their expectations for future interest rate hikes. The latest "dot-plot" revealed in March no more rate hikes in 2019, down from 2 hikes in December. The median FOMC member rate hike expectations beyond 2019 have also been lowered.

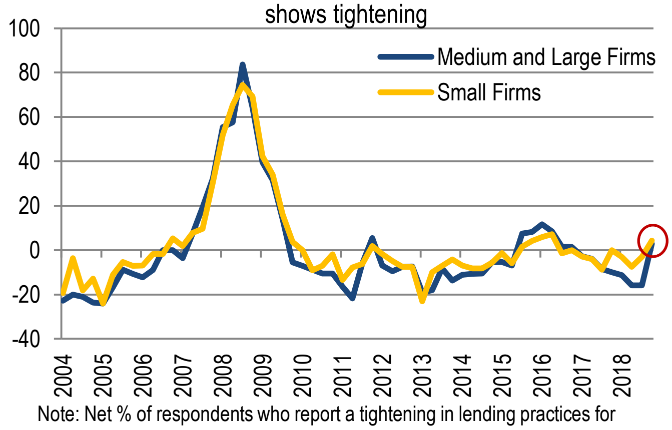
First, we believe that the most relevant interpretation of an inverted yield curve is also the most straightforward. According to the expectations theory of the term structure of interest rates, longer-term interest rates represent financial markets expectations of future short-term rates.[2] When longer-term interest rates fall below shorter-term rates, it implies that financial market participants expect that central banks will lower short-term rates in the future because, for instance, inflation and growth will weaken; as they do during a recession.

However, it is difficult to find a compelling explanation as to *why* a flattening yield curve would *cause* a recession. In fact, one could very much argue that a flattening yield curve is a sign of a strong economy. Indeed, as the U.S. yield curve flattened significantly in the last two years, evidenced by the gap between the 10-year and the 2-year government bond shrinking from 123 bps to 18 bps between January 1st 2017 and April 2nd 2019, the U.S. economy grew by an average annualized quarterly rate of 2.7%. As Tim Duy, Economics professor at the University of Oregon puts it, the business cycle moving to a mature stage and towards full employment prompts the Federal Reserve to increase short-term interest rates, which flattens the yield curve.

On the other hand, financial institutions, by lending "long" and borrowing "short", may play a role in causing the economy to slow down when the yield curve flattens and eventually inverts. This is because as lending becomes less profitable, a contraction in incentives to extend credit to the private sector can eventually cause a slowdown. While banking credit conditions have recently tightened, it remains to be seen whether it will cause the economy to slow down to the point of triggering a recession (chart 3). Excessive monetary tightening is often blamed for triggering recessions. However, since the beginning of the year, central banks globally, in our view, have reacted pre-emptively to minimize the risk of such a scenario.

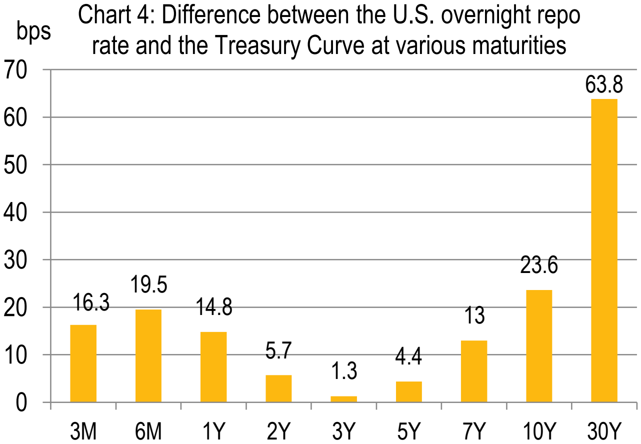
Using the Fed overnight repo rate (2.25%) as a proxy for financial institutions' borrowing costs, the entire U.S. yield curve is currently 18 basis points above the repo rate on average (chart 4). This compressed positive spread is low, but better than the complete inversion below the 30-year rate as of last week. In Canada, longer term rates are mostly (up to 20 years) *below* the Bank of Canada overnight interest rate target (1.75%).

Chart 3: Senior Loan Officer Survey for Businesses shows tightening



Note: Net % of respondents who report a tightening in lending practices for businesses.
Source: Federal Reserve.

Chart 4: Difference between the U.S. overnight repo rate and the Treasury Curve at various maturities



Note: As of April 2, 2019.
Source: Bloomberg Finance L.P.

[2] Assuming risk-free bonds and completely liquid secondary markets.

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A steepening yield curve warrants a smaller bond exposure

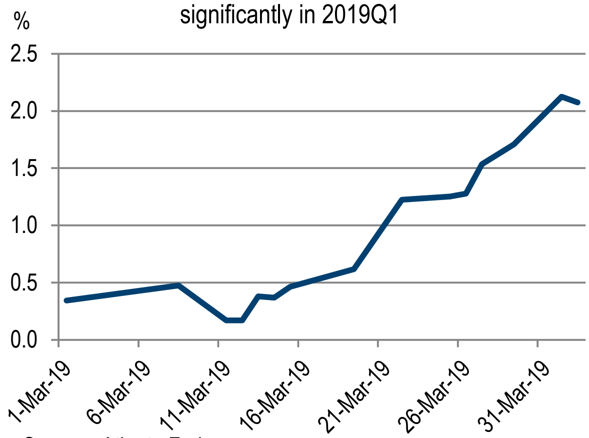
This being said, a deeply inverted yield curve would make us worry about both the economic outlook and the performance of equity markets which have rebounded sharply in the first quarter of 2019. However, significant driving forces push us to foresee a strengthening global economy in the second half of the year and consequently a steepening in the yield curve in the months ahead. First, central banks have committed to remain dovish in 2019, and possibly beyond, even if the economic outlook brightens. This will contain shorter-term rates and should allow longer term rates to rise marginally as growth and inflation expectations will have bottomed.

Second, as we have argued at the beginning of March, we believe that a Chinese-driven acceleration in economic activity going into the second half of this year is in the card. Chinese economic data received over the last month have supported this view: for March 2019, the Citigroup economic surprise index for China was up by 2.5 points relative to the end of February (chart 1). Importantly, the Caixin China manufacturing PMI came back into expansion territory (50.8) for the first time since November.

Going forward, we will keep an eye on China's total social financing, which had increased sharply in January, as a confirming sign that the Chinese government is indeed re-inflating the economy. Closer to us, recent data suggests that growth will not be as weak as originally thought. In the U.S., the Atlanta Fed 2019Q1 GDPNow forecasts increased from 0.3% Q/Q SAAR at the beginning of March to 2.1% on April 2nd (chart 5).

In Canada, while growth was expected to be around 0 in 2019Q1, with economists flirting with technical recession calls, the very strong 0.3% m/m growth figure for January brought quarterly GDP growth estimates closer to 1.0% Q/Q SAAR. The continuation of this trend should push longer-term rates slightly higher, which has already been the case since last week. All considered, since a steepening yield curve would dampen bond returns, we recommend a slight underweight in bond exposure for April. We maintain our allocation to government (70%) and corporate (30%) sector bonds. Conversely, a small overweight in equities is thus warranted (see table below).

Chart 5: Atlanta Fed GDP Nowcast rallied significantly in 2019Q1



Source: Atlanta Fed.

Keeping overweight exposures to U.S. and emerging markets

In the last two months, the U.S. equity market has outperformed the Canadian market and we believe it will continue to do so. Some tactical indicators included in our tactical asset allocation model (slightly better momentum in the U.S.

versus Canadian unemployment and real short-term interest rate differentials) favour the United States relative to Canada. Moreover, positive downward momentum in U.S. initial jobless claims and better momentum in the U.S.-Germany unemployment rate favour overweighting the U.S. equity market. Since a trade deal with China, which we believe is imminent, would lift emerging markets (EM), we are recommending an overweight position in EM. Moreover, shorter-term forward-looking indicators, such as a positive momentum in cooper prices, also favour emerging equity markets currently.

Price and earnings momentum recommends a mix of defensive and cyclical sectors

Every three months, we update earnings-per-share (EPS) growth estimates and price return momentum data for the Canadian and U.S. equity sectors. These are important components of our tactical sectoral asset allocation. For April 2019, very strong price movements combined to a bit more optimistic outlook for EPS growth are supporting our decision to overweight the **Information technology**, **Telecommunication services** and **industrials**. We also continue to like the **consumer staples** sector, which was a strong performing sector over the last three months (+10.2% and +11.9% in Canada and the U.S. respectively). Finally, we continue supporting **financials** which are poised to benefit if, as we expect, the yield curve steepen in April and the economy shows further signs of stabilizing as it did over the last few days.

Recommended Portfolio as of April 2019

Asset Classes & Regions	Recommended Weightings (%)	Benchmark Allocation (%)	Over/Underweights (%)	Recommendation
Bonds	45.0	50.0	-5.0	-
Government	32.0	34.4	-2.4	-
Corporate	13.0	15.6	-2.6	-
Equities	55.0	50.0	5.0	+
Canada	20.0	20.0	0.0	=
United States	19.5	16.0	3.5	+
Other Developed Markets	11.6	11.6	0.0	=
Emerging Markets	3.9	2.4	1.5	+

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