

Market Commentary

Fourth Quarter 2016



CI Investment Grade Bond Fund

A sharp move higher in government bond yields globally, particularly post-U.S. election, was the key theme in fixed-income markets this quarter. Ten-year bond yields in the United States, Canada, and Germany were 85, 74, and 33 basis points higher, respectively. The move higher in yields was precipitated by expectations the U.S. Federal Reserve Board would look to increase interest rates into year-end and that the incoming administration in the United States would pursue policies leading to higher economic growth, and therefore higher inflation and increased levels of government indebtedness.

The sell-off in interest rates was countered, somewhat, by a tightening of investment-grade corporate bond credit spreads. The positive tone in credit markets was attributable to (1) stronger equity markets, (2) firmer commodity and energy prices, (3) renewed assumptions about better economic growth, (4) tax reform in the United States that would benefit corporations, and (5) all-in higher yields. The U.S. investment-grade credit default index (CDX) tightened seven basis points in the quarter. However, cash credit spreads outperformed CDX, tightening 23 and 9 basis points in the United States and Canada, respectively. Cash credit spreads in the European market had a somewhat subdued performance given concerns about the outcome of the Italian Constitutional Referendum in early December.

The fund derives its return from the movement in government bond yields and credit spreads. While the rise in government bond yields was negative for performance, the tightening in corporate bond spreads generated positive excess return.

We believe the market narrative has begun a very sharp short-term change. Here are some characterizations and comments about the narrative:

- Central bank monetary policy has reached its limits and central banks can no longer suppress interest rates and volatility. The current technical breakdown of rates globally is aggressively negative.
- Populist electoral results are challenging established fiscal policy and government debt convention. These conventions are likely going to be tested in the United States, the U.K., and further in Japan. China is already testing them but lack of transparency provides little understanding of their limits or consequences.
- Inflation expectations have risen and the recent price action in energy and industrial metals prices (while curious) projects further upside in inflation breakevens and headline inflation.
- The current economic cycle, while extended, will be lengthened by 18-24 months.

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- The volatility genie is out of the bottle.
- Whether we believe in the validity of the narrative or not, we need to understand it, respect it, and respond to it.

Interest rates have clearly and decisively broken our previous short- and long-term ranges. We have entered a new range, with the old upside level – 2.25% – now presenting some serious resistance. We would suggest that the new short-term range in 10-year U.S. Treasuries is 2.25-2.65% and the long-term range is 2.00-3.00%.

For IG corporate credit, the broad market consensus in 2017 is for spreads to tighten, but for market volatility, sector-specific risks, and idiosyncratic risks to have a more potent negative impact to excess returns than in the past few years.

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