Market Commentary
Fourth Quarter 2018

Sentry Canadian Bond Fund

Market overview

- The fourth quarter of 2018 featured continued tightening of global financial conditions, and despite the U.S. Federal Reserve Board (Fed) delivering a dovish hike in December, markets experienced heightened volatility. Almost every major asset class ended the year with negative returns, while global government bonds outperformed and U.S. three-month T-bills returned 1.8%.
- In developed markets, the U.S. continued to grow at a moderate pace and payroll growth remained robust even though the Fed raised rates by 100 basis points through the year. On the back of this monetary policy tightening, the dollar continued to strengthen against most G10 currencies in the fourth quarter, while the 10-year U.S. Treasury yield collapsed from a high of 3.23% in early October to 2.68% by the end of the year. The recent flattening of the U.S. Treasury yield curve is indicative of market worries about a policy misstep by the Fed.
- In Canada, the Bank of Canada (BoC) hiked its policy rate in October, the third time this year, to 1.75%. Since then, the collapse in energy prices has resulted in downward revisions to the growth and inflation outlook over the year ahead. Against this backdrop, the Canadian 10-year yield dropped by 46 basis points to 1.96% at year-end, while the Canadian dollar declined by almost 6% against the U.S. dollar through the quarter.
- In Europe, recent economic data has worsened as PMIs slumped further, particularly in France as the "gilets jaunes" protests have slowed down activity. Germany too has seen pronounced decline, and in line with other developed markets, the German 10-year yield also declined during the fourth quarter to end 2018 at 0.24%. From a political standpoint, Italy reached an agreement with the European Commission on its budget plan and this helped Italian government spreads outperform other peripheral spreads in Europe.

Performance summary and factors affecting fund performance

- The fund returned 1.2%, underperforming its benchmark, the FTSE/TMX Canada Universe + Maple Bond Index, in the fourth quarter.

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- The total return outcome of the portfolio was primarily driven by a significant drop in Canadian interest rates, with some offset coming from a widening of Canadian government and corporate credit spreads.
- On a relative to benchmark basis, government credit exposure and net currency positioning were the most significant contributors to performance, while corporate credit exposure was the main detractor.
- Underweight government credit exposure was alpha accretive, as spreads in this sector widened 16-20 basis points (bp) across the curve during the reporting period. Overweight U.S. dollar positions, net of hedges, also added to portfolio alpha, as the U.S. dollar rose about 5.7% against the Canadian dollar during the reporting period. The foreign currency exposure of the portfolio is actively managed through a hedging overlay.
- Overweight corporate credit exposure was a drag on alpha, as spreads widened in this sector over the quarter. Canadian investment-grade corporate credit spreads widened by a substantial 33bp over the quarter.

Portfolio activity and positioning

- Portfolio duration is moderately short relative to the benchmark, featuring an overweight in the seven-year to 10-year area of the yield curve and an underweight in the 20-year portion.
- In the spread product domain, we are overweight corporate credit and underweight Canadian government agency and provincial debt.
- In the fourth quarter, we added to duration gradually in the 10-year area of the yield curve amid the shift lower in longer-term interest rates. We also increased our yield curve steepening exposure by selling duration-equivalent quantities of 30-year government bonds in favour of 10-year bonds. Our concern was that the fall in energy prices, tightening financial conditions, and trade tensions between the U.S. and China would have a dampening effect on the Canadian economy, compounding the influence of an emerging slowdown domestically and abroad, and limiting scope for the BoC to raise interest rates, prompting a steepening of the yield curve.
- During the reporting period, our underweight government credit position was held amid concerns that budgetary deficits and borrowing requirements of various levels of Canadian governments would rise in an environment of softer economic activity, leading to wider credit spreads in this sector.

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Market outlook

- Economic indicators in the U.S. seem mixed – while consumer sentiment and labour markets continue to be healthy, business activity is showing signs of slowing down. Given the recent communication from the Fed, it seems unlikely it can deliver more than one hike in 2019, and this should allow the U.S. economy to continue growing at a moderate pace, even as fiscal stimulus fades.
- The sharp repricing of rates across developed markets over the past few months has created opportunities for risky assets, leaving some room for credit spreads to narrow in the near term. As markets discount the end of Fed rate hikes alongside a slowing but still growing above-potential U.S. economy, the risk of weakness in the U.S. dollar begins to surface, which would in turn ease global and emerging markets' financial conditions in 2019.
- Prospects for additional rate hikes by the BoC have eroded, with markets pricing in less than one 25bp increase over the next 12 months. The collapse in energy prices, tightening financial conditions, and trade tensions between the U.S. and China are seen slowing the economy and dragging inflation below the 2% target of the BoC.
- On energy concerns in particular, the discount for Canadian crude relative to global oil prices has eased of late courtesy of imposed production cuts, but additional pipeline capacity is required for this development to be sustained. Meanwhile, global oil prices remain at depressed levels that are unlikely to prompt a pick-up in energy sector capital expenditures.
- We believe that the European Central Bank may have missed its chance for policy normalization. Having ended quantitative easing in December, its next move in 2019 might be a loosening of policy through an extended TLTRO program that provides inexpensive funding for banks to lend to the real economy in hopes that this lending will be used to boost growth.
- In the U.K., the focus continues to be Brexit, with a March 29 deadline fast approaching and inadequate support in Parliament for the negotiated agreement.

Class F Returns (in %) as at December 31, 2018	1 year	3 year	5 year	Since inception (8/31/2012)
Sentry Canadian Bond Fund	0.5	0.5	2.3	3.0

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