Market Commentary
Second Quarter 2018

Signature Canadian Bond Fund

The pickup in volatility in capital markets that we witnessed in the first quarter of 2018 continued in the second quarter as geopolitical uncertainty led markets to reprice risk premia globally. A contributor to volatility was the escalation in trade war rhetoric that ultimately materialized into action as the U.S. levied aluminum and steel tariffs against its trading partners including China, Japan, the European Union, and Canada.

Against this backdrop growth in the U.S. remained robust, enabling the U.S. Federal Reserve (Fed) to continue tightening monetary policy by raising interest rates for a second time this year at its June meetings. As U.S. monetary policy continued to diverge from the rest of the world and put pressure on the global cost of capital, U.S. corporate bond spreads and emerging market bond spreads steadily widened. Despite these developments, the Fed signalled intentions to raise interest rates two more times before the end of the year. Clearly, the hurdle for the Fed to cease hiking is significantly higher than in 2013 (with the taper tantrum) or in 2016 (with the deflation scare).

The Bank of Canada has remained on hold after hiking interest rates in January to 1.25%. A combination of mixed economic data throughout the second quarter as well as business uncertainty induced by NAFTA re-negotiations persuaded the Bank of Canada to proceed with caution in its hiking cycle. Elsewhere, a new populist government in Italy renewed concerns about the stability and integrity of the European Union and led to a blowout in Italian government bond spreads (to German government bonds). Despite higher political risks and a noticeable slowdown in growth momentum in the European Union, the European Central Bank (ECB) revised its inflation forecast higher and announced its intentions to wind down quantitative easing at the end of 2018. However, it introduced forward guidance and set expectations that interest rates would remain at current levels until at least the summer of next year. In the U.K., the Bank of England has been on hold year-to-date as economic data have significantly missed official forecasts and Brexit negotiations effectively stalled amid political wrangling within the U.K. parliament.

The response across global bond markets saw 10-year interest rates in Canada and the U.S. rise in the second quarter to 2.86% and 2.17%, respectively. However, over the same period, 10-year interest rates fell in Germany and the U.K. to 0.3% and 1.28%, respectively.

Canadian investment-grade corporate bonds widened four basis points in the second quarter of 2018 due to a general selloff in risky assets, but much less than U.S. investment-grade bonds which were +14 basis points wider due to shareholder-friendly merger and acquisition (M&A) activity. Canadian investor demand for corporate bonds remained good given new issuance volumes running at record levels.

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The fund advanced by 0.2% in the second quarter. The total return outcome of the portfolio was primarily driven by a modest drop in longer-term Canadian interest rates with some support coming from select Canadian government and corporate credit spread exposure.

Residual currency exposure was the most significant contributor to performance, while duration and yield curve positioning was the main detractor.

Within the spread product arena, corporate credit exposure was alpha accretive, offset by the effects of government credit positioning.

U.S. dollar exposure net of hedges was supportive for alpha, as the U.S. dollar gained ground against the Canadian dollar over the quarter. Portfolio foreign currency positions are actively managed through a hedging overlay.

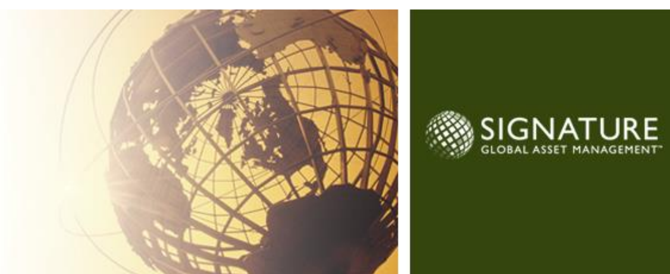
Duration and yield curve positioning subtracted from portfolio alpha, coming from the underperformance of our U.S. duration exposure relative to Canadian duration, and the flattening of the Canadian yield curve. The 10-year to 30-year segment of the Canadian yield curve flattened eight basis points during the quarter, while the U.S. 10-year yield rose some seven basis points more than its Canadian counterpart in the same timeframe.

Portfolio duration is moderately short, featuring an underweight in the 10-year to 20-year area of the yield curve. Provincial bonds are used to manage this yield curve position while collecting better income. In the spread product sphere, we are cautiously overweight corporate credit, underweight Canadian government agency debt, and retain long positions in U.S. inflation-linked bonds.

In the second quarter, we lowered Canadian duration mainly in the 10-year area of the yield curve. Late in the quarter, we sold our U.S. agency mortgage holdings, moving some of the duration back to the Canadian market.

Over the medium term, higher global trade barriers and the emergence of populist politics and policies could result in a buildup of inflationary pressures. This increases risks of monetary policy errors if central banks are perceived to fall behind the curve, so we remain constructive on inflation-linked bonds.

In the near term, we continue to monitor developments in global trade wars although we would note that global growth remains constructive. Until there is more clarity on trade negotiations for NAFTA, Brexit, and U.S.-China, we expect volatility to remain elevated and note that the probability of downside risks across global capital markets has risen. Therefore, we stand ready to manage



these risks in the portfolio by adding duration (interest rate exposure) and/or reducing exposure to spread risk premia.

Class F Returns (in %) as at June 30, 2018	Year-to-date	1 year	3 year	5 year	10 year
Signature Canadian Bond Fund	0.0	-0.3	1.0	2.6	3.7

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