Market Commentary
Third Quarter 2018

Signature Canadian Bond Fund

After a volatile first half of 2018 during which the risk premium was repriced globally, risk assets found some reprieve at the beginning of the third quarter. However, the persistence of U.S.-China trade tensions and continued tightening of global financial conditions triggered another bout of volatility, particularly in emerging markets.

In developed markets, economic activity remains on track but has become increasingly tilted toward the U.S. Indeed, solid U.S. economic performance has been a dominant driver of global financial markets in recent months, strengthening the U.S. dollar against most major currencies (with the notable exception of the Canadian dollar) and causing U.S. interest rates to rise. U.S. economic developments are in line with the U.S. Federal Reserve's projections, creating a high hurdle for the Fed to relent – or even pause – on its current path of tightening monetary policy.

In Canada, the Bank of Canada (BoC) hiked interest rates in July, the second time this year, to 1.5%. While economic data have evolved broadly in line with BoC forecasts, business uncertainty induced by NAFTA (now U.S.-Mexico-Canada Agreement, or USMCA) re-negotiations has led the BoC to proceed with caution in its rate-hiking cycle, keeping rates unchanged at its September meeting. However, the resolution of trade negotiations with the U.S. and Mexico removed what was arguably the single greatest risk to the BoC policy rate path.

In Europe, the populist Italian government will continue to cause grief for the European Union (E.U.) with its recent announcement of a 2.4% budget deficit for 2019. While this figure meets the E.U.'s Stability and Growth Pact of not running a budget deficit in excess of 3%, the E.U. will likely push back given the previous Italian government's commitment to shrink the budget deficit.

Against this backdrop, global bond markets saw interest rates rise across developed markets. In North America, 10-year rates in Canada and the U.S. ended the third quarter at 2.43% and 3.06%, respectively, while in Europe, 10-year rates reached 0.47% in Germany and 1.57% in the U.K.

The total return outcome of the portfolio was primarily driven by a rise in longer-term Canadian interest rates, with only a modest offset coming from Canadian government and corporate credit spread exposure. Corporate credit exposure and Canadian duration positioning were the most significant contributors to performance, while residual currency exposure net of hedges was a small detractor.

Duration and yield curve positioning added to portfolio alpha, stemming from our moderate duration position in longer maturity Canadian bonds. The Government of Canada 10-year bond yield rose by some 26 basis points over the quarter. Corporate credit exposure was also alpha accretive, as spreads narrowed five basis points in this sector among the 10-year and shorter maturities during the reporting period.

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U.S. dollar exposure net of hedges was a slight drag on alpha, due to the U.S. dollar slipping lower against the Canadian dollar in the quarter. Portfolio foreign currency positions are actively managed through a hedging overlay.

Portfolio duration is moderately short, featuring a low exposure in the 10-year to 20-year portion of the yield curve. Provincial bonds are used to manage much of this yield curve position, while collecting better income. In the spread product sphere, we have a modestly high exposure to corporate credit, low exposure to Canadian government agency debt, and retain small long positions in U.S. inflation-linked bonds.

In the third quarter, we added modestly to Canadian duration mainly in the 10-year area of the yield curve amid the shift higher in longer-term interest rates. Later in the period, we reduced the size of our position in Canadian government agency debt, reallocating exposure from the provincial market.

In the near term, we expect positive economic momentum in the U.S. to continue, which would be supportive of credit spreads in this market. This should also enable the Fed to continue tightening monetary policy by raising interest rates so we expect that short-term interest rates will continue to rise in the U.S.

In the medium term, we continue to closely monitor inflation dynamics in the U.S., as additional wage pressures or further escalation of the U.S.-China trade war could put upward pressure on inflation expectations. Such a scenario could force the Fed to raise interest rates faster than has been currently communicated to the market.

While financial conditions have become less accommodative globally, the speed at which the Fed is normalizing monetary policy is outpacing other developed market central banks. A growing divergence between U.S. rates and the rest of the world could continue strengthening the U.S. dollar. A sharp tightening of global financial conditions could lead investors to shed risky assets.

In the geopolitical sphere, we continue to monitor developments in the U.S.-China relationship and the ongoing Brexit negotiations.

Although the growth outlook remains constructive in major economies, particularly in the U.S., we note downside risks as global markets adjust to the reversal of accommodative financial conditions, which have been in place for the last decade. As such, we stand ready to manage these risks in the portfolio by adding duration (interest rate exposure) and/or reducing exposure to credit spreads.

Class F Returns (in %) as at September 30, 2018	Year-to-date	1 year	3 year	5 year	10 year
Signature Canadian Bond Fund	-1.0	0.3	0.6	2.4	3.6

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