Manulife Asset Management™

Global Intelligence: Summer 2014

MARKET OUTLOOKS

NORTH AMERICAN FIXED INCOME

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First-half upside surprises; continued corporate debt opportunities in H2

The US economy continues to strengthen after its dismal performance in the first quarter. Employment is improving, the housing market is in better shape with room to expand, and the oil and gas sectors continue their upswing. As a result, we expect interest rates will go up faster in the US than in Canada, given the former's stronger economic footing. That being said, Canada tends to export more to the US when the US is strengthening to piggyback on its economic performance. In this context, we are expecting the US bond market to continue to underperform Canada slightly in 2014.

We view Bank of Canada Governor Stephen Poloz's more dovish stance (versus his predecessor Carney's) as another driver of Canadian bond market outperformance in the second half. Poloz favors a weaker Canadian dollar to help boost manufacturing and exports. That would lead us to expect interest rate increases in Canada will not happen before the Federal Reserve (Fed) begins raising rates.

At the beginning of the year, many investors were focused on the possibility of higher interest rates resulting in weaker bond market returns. Though we were not pessimistic, we were expecting North American bond markets to generate returns in the range of 1.5% and 2%. Since then, both US and Canadian markets have delivered pleasant upside surprises, with the Canadian bond market returning 4.8% and the US bond market returning 4.2% in the first half.

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We see a number of factors driving strong first-half fixed income performance in North America. The biggest component has been weak economic activity, particularly Q1 in the US and to some extent in Canada due to the severe winter. On top of that, a number of geopolitical issues have surfaced or continued to simmer this year, including the standoff in Ukraine, developments in Iraq that have impacted oil markets, and the escalating situation between Israel and Palestine, to name a few. This has resulted in a flight to quality, pulling yields down and fueling bond market performance. Corporate bonds have done particularly well, with spreads narrowing against government bonds by an average of 10-15 bps in Canada.

Looking at the second half of the year, we expect a minor bond market selloff, with US and Canadian interest rates in the 10-year range rising by a quarter point to half a point. A range of factors contributed to the decline of interest rates in the first six months of the year. We think there is a strong possibility that decline will reverse in the coming months, as the US economy rebounds and pushes interest rates up further. We expect an increase in rates by 25 to 50 bps translating into a negative second half return of -0.5-2% and a positive full-year return of 2-4% for US and Canadian bond markets on a combined basis.

Against this backdrop, we continue to see US and Canadian **corporate debt**, **shorter duration debt** and **higher-yield debt** as good places for investors to be. Corporate bonds — in particular high-yield bonds — did very well in the first half and we are expecting continued good performance given the potential for higher interest rates on the back of a stronger economy, stronger corporate balance sheets, and stronger credit metrics. Those conditions help keep spreads safe, making them more likely to stay where they are or tighten.

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Floating rate notes issued by investment grade corporations may present another interesting opportunity towards end of the year as the Fed provides more clarity on its timing and process for raising rates. The prices of floating rate notes will stay at par and won't decline while investors continue to receive income from yields.

When the Fed begins to make clearer statements about raising rates, we expect the market to begin selling bonds in the two- to five-year range. In that case **the front end of the yield curve** may pose challenges for investors. When the Fed starts raising rates gradually over a period of time as we anticipate they will, at some point we will start mitigating duration risk by reducing the duration of our portfolio as a whole.

In the coming months we will be watching for key data releases — including inflation, employment, and GDP growth numbers — that will be critical gauges of the health of the US and Canadian economies. While inflation is still below the 2% Canadian and US targets, headline and core CPI has started to pick up in both countries. Higher inflation could lead the Fed to move earlier and faster which would prompt us to reduce the two-to-five-year exposure in our portfolio more quickly.

We are also staying vigilant regarding geopolitical events. Though we have seen the market grow complacent about financial risk this year, we consider these inherently unpredictable events to be important variables — ones with the potential to dent confidence, restrain the recovery, and impact bond markets with a flight to government securities.

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