

Weekly Note

To us there are no foreign markets.™

Investment Team

Robert Jukes
Global Strategist
T: 44.207.523.4594
robert.jukes@canaccord.com

Michael Quach
Senior Research Analyst
T: 44.207.523.4528
michael.quach@canaccord.com

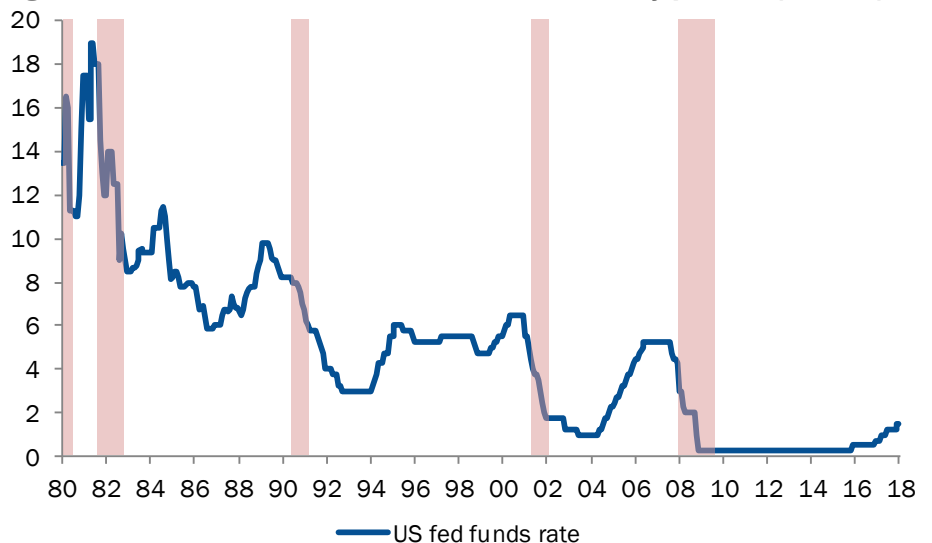
Ian LeCroy
Research Analyst
T: 416.867.2643
ian.lecroy@canaccord.com

Never Gonna Give You Up

The US Federal Reserve left its key benchmark interest rate unchanged last week but signalled the prospect of an interest rate rise in March. Even though the central bank expects economic growth to continue and inflation to pick up this year, the pace of monetary policy tightening remains slow. With the overnight interest rate between 1.25% and 1.50% it also remains at a relatively sanguine level and financial conditions remain supportive for the economy. Indeed, the initial interest rate rises of a cycle rarely point to the risk of impending economic contraction, instead they are usually associated with further positive returns from the equity market. Returns from fixed income are usually more challenged in a rising interest rate environment, however, but there are good diversification reasons for holding onto bonds. The term premia also appears to be restraining the upward drift in yields, making it unlikely that they will rise aggressively from here.

Figure 1 highlights the US Fed Funds rate and the NBER US recessionary periods. The risk of a recession usually occurred nearer the peak of an interest rate cycle. Even though rates will likely peak at lower levels than seen previously over the past forty or more years, the peak of the rate cycle is unlikely to be soon given the slow pace of tightening,

Figure 1: US Fed Funds rate and NBER recessionary periods (shaded)

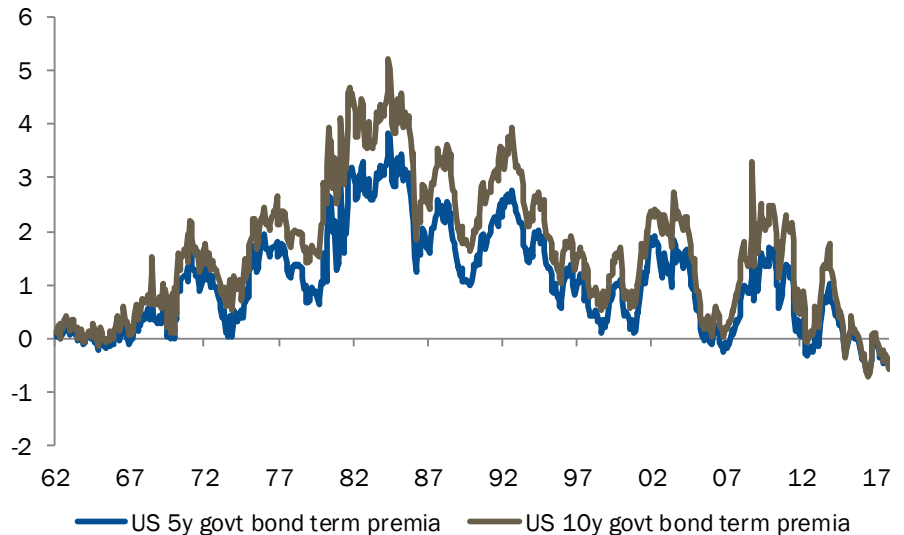


Source: Datastream, Canaccord Genuity Wealth Management. Past performance is not a reliable indicator of future performance

The yield on US 10-year government bonds has risen from the recent low of 2.1% in early September last year to a current level of 2.8% on the back of increased market expectations for stronger growth and inflation. That is quite a move over a relatively short period, but we expect that will mark the bulk of the adjustment over the near term. The relatively flat shape of the curve (the difference between long and short-term bond yields) suggests that growth and inflation expectations remain relatively low, which also suggests that longer-term bond yields are likely to remain low by historic standards.

A more formal way of looking at this involves an examination of the term premia i.e. the compensation required by investors for bearing the uncertainty of long term interest rates. This is because the long run interest rate is made up of expectations about short-term interest rates plus the term premium. Figure 2 highlights the sharp fall in the Treasury term premia in the past decade, which essentially reflects the expectation that interest rates are going to be lower for longer, and thus bond yields are likely to remain relatively low. Even though the path of short-term interest rates is likely to continue upwards from here, the falling term premia will mitigate the associated rise in long run bond yields.

Figure 2: US 5y and 10y Treasury term premia

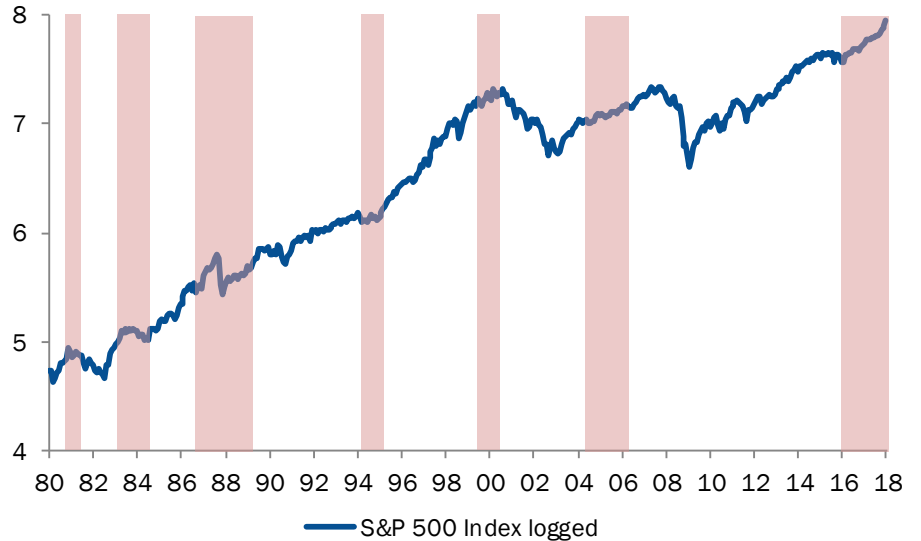


Source: NY Fed, Canaccord Genuity Wealth Management. Past performance is not a reliable indicator of future performance

From an equity perspective, the prospect of further rate rises should be largely offset by the still overall accommodative financial conditions and positive economic and earnings growth momentum. Financial conditions in the US as measured by the Chicago Fed remain as loose as ever (going back to 1971). Meanwhile, key leading indicators such as the Purchasing Managers Index (at 59.1 in January 2018 is comfortably above the neutral 50 level) and the Michigan Consumer Sentiment (at 95.7 is towards the upper end of the last ten years) are pointing towards a relatively robust economic activity.

It is not necessarily the case that rising interest rates coincide with negative equity performance. Figure 3 highlights the S&P 500 Index performance since 1980 with periods of rising interest rates highlighted by the shaded areas. As the chart shows, the S&P 500 Index has registered positive performance during periods of rising rates.

Figure 3: S&P 500 Index performance (logged) and periods of rising interest rates (shaded)



Source: Datastream, Canaccord Genuity Wealth Management

For now, we remain positive on equities given the good economic momentum and accommodative monetary policy, but see some near term and limited downside risk to bonds. The risk of a damaging increase in US government bond yields is likely to be contained by the low term premia, and as such we continue to expect that bonds will serve as a good diversifying asset class within a multi-asset portfolio.

All information is given as of the date appearing in this document and Canaccord Genuity Wealth Management (CGWM) does not assume any obligation to update it or to advise on further developments related. All this information has been compiled from sources believed to be reliable, but the accuracy and completeness of the information is not guaranteed, nor in providing it do CGWM assume any liability.

All views expressed in this document are provided for informational purposes only and does not constitute an offer or solicitation to buy or sell any securities. The statements expressed herein are not intended to provide tax, legal or financial advice, and under no circumstances should be construed as a solicitation to act as a securities broker or dealer in any jurisdiction. All views are intended for general circulation to clients and do not have any regard to the specific investment objectives, financial situation or general needs of any particular person.

Forward-looking statements and past performance are not guarantees of future results. To the fullest extent permitted by law, neither CGWM nor its affiliates or any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of the information contained in this document. Canaccord Genuity Wealth Management in Canada is a division of Canaccord Genuity Corp. Member – Canadian Investor Protection Fund and the Investment Industry Regulatory Organization of Canada.