How Low Can We Go?

It was a bumpy ride in August with almost all major markets across the globe posting negative returns. The S&P 500 was down around 1.8%, while the Canadian market was up 0.2%. While another month has come and gone, the market's attention continues to center on the U.S. and China's ongoing quarrel. As the trade war intensified (again) during the month of August, signs of a global slowdown continued to increase.

Many investors sought refuge in bonds as the global demand for bonds surged, forcing prices up and rates down, resulting in one of the most dramatic downswings in long-term government yields in recent memory. During the month of August, the benchmark U.S. 10-year Treasury note yield plunged by 0.5%, the largest calendar month decline in over four years, while the 30-year U.S. Treasury bond yield fell to an all-time low. Long-term rates dove so low that yields on the 3-month and the 2-year notes exceeded the 10-year rate – an occurrence that we have discussed multiple times so far this year, known as yield curve inversion. The inversion of the yield curve is often an indicator of an eventual recession. While the U.S. bond market is certainly flashing some warning signals and yields are at lows, across the pond the situation is much more unusual with various countries offering bonds with negative yields.

Worldwide there is currently over $17 trillion in government bonds with negative yields (none in Canada or the U.S.). This represents over one quarter of the global bond market. The concept of negative-yielding debt is a hard one to grasp and may sound counter-intuitive. It essentially means that when you invest in a bond, the amount you receive back is less than the total money you initially invested. Not so enticing, is it? This is the current reality across a lot of Europe and Japan. Certain investors will always hold government bonds. Because of the safety and liquidity that government bonds provide, these investors are willing to pay a premium even knowing that it will ultimately result in a loss. While negative yields are unusual, this does not necessarily mean disaster. The majority of these negative-yielding bonds are purchased by large investors such as pension funds and financial institutions, which require a safe place to park large amounts of assets. The amount of debt trading with historically low or even negative yields, combined with the worries of a global slowdown, is enough to unnerve investors but our outlook remains unchanged. We do not foresee an immediate recession on the horizon in the U.S. or Canada.

In Canada, GDP growth in Q2 was strong but the details were less exciting. At first glance, real GDP growth of 3.7% annualized for Q2 shows a surge in the Canadian economy and a huge beat to expectations, but a deeper dive certainly tempered this spirit. This impressive Q2 result was mainly a result of only one factor, net exports. This trade-driven boost is a temporary factor largely driven by a normalization in energy flows and price differentials coming back in line after the Alberta curtailments. Underlying areas of weakness included business investment, sliding over 16% in the quarter, and household consumption growth posting a 7-year low. On a positive note, following five straight quarterly declines, residential construction rose over 5% in Q2, a good sign for the Canadian housing market, which has continued to stabilize as of late.

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After feeling the effects of the tightened mortgage stress test rules, the Federal government has introduced a new program designed to lower mortgage costs for eligible Canadians, the First-Time Home Buyer Incentive (FTHBI). Prospective homebuyers can apply for a loan from the Canadian Mortgage and Housing Corporation (CMHC) of up to 5% for an existing home or up to 10% for a new build. While the incentive aims to assist young people in buying their first home, eligibility is restricted including requirements that the purchaser's household income must be below $120,000. The FTHBI loan is interest-free and must be repaid when you sell your home or after 25 years. Instead of charging interest, the loan is structured so that the government owns an equity share in the property. You must repay the government the same percentage of the sale value or of the home's current value if you still own it after 25 years. This program should incentivize new homebuyers and may provide a stimulus to the Canadian housing market following stricter mortgage rules and foreign-buyer taxes.

With increasing signs of a slowdown, mounting trade tensions and a pending Brexit looming in the U.K., we continue to favour a more defensive position in the portfolio. Our overall asset mix remains slightly underweight equities. While many investors may feel uncomfortable during these volatile times of increased market uncertainty, we remind our clients to stay focused on their long-term goals and to stay the course.

This monthly commentary is produced by our in-house research team. If you are interested in learning more about our investment solutions please contact us at info@cwbwealth.com or 1.855.292.9655. You can also visit our website: cwbwealth.com.

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