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AVIVA INVESTORS CANADA INC.
FIXED INCOME QUARTERLY COMMENTARY
STONE GLOBAL BALANCED FUND

GLOBAL ECONOMIC REVIEW AND OUTLOOK

Economic Review Q2

Data released in the June quarter showed that growth slowed in the major developed market economies in the first three months of 2018. According to the OECD, GDP growth amongst the G7 economies slowed to an annualised pace of 1.3 per cent, down from 2.3 per cent in 2017 Q4. While the slowdown was broad-based across the majors, we do not think it signals a fundamental slowdown. Indeed, in each of the major economies there were one-off factors (including unseasonably cold and snowy weather) that should largely reverse in Q2.

Trade tensions between the US and the rest of the world escalated into trade skirmishes, in particular between the US and China. The risk is that tensions escalate into a full-scale trade war, threatening to reverse the progress made in lowering trade barriers over the past 25 years. During the quarter the US imposed new tariffs on steel and aluminium imports from Canada, Mexico and the EU and also announced tariffs on $34 billion of Chinese goods. More significantly, the Trump administration threatened tariffs on as much as $400 billion of Chinese goods, almost the entire value of US goods imports from China, should the Chinese retaliate with tariffs of their own.

Chinese growth was a little better than we expected in Q1, but has shown some signs of slowing more recently. We expect growth this year to be around 6.3 per cent, with modest easing in reserve requirements to more than offset higher policy rates.

Market Review Q2

Global equities endured periods of volatility during the second quarter of 2018 but gains made by overseas markets were eroded for US investors by a stronger US dollar. The MSCI World Index returned 1.93% in USD. The corporate earnings announcement season in April and May – when US-listed companies released their results for the March quarter – highlighted a high level of profitability. This helped to support sentiment towards equity markets globally. Volatility picked up towards the end of the quarter as investors focused on the potential for a 'trade war' to dampen trade volumes and, in turn, corporate profitability. The Chinese market – and others in the neighbouring Asia region – was hardest hit, as the US suggested it will introduce tariffs on a wide range of goods imported from China.

Government bonds continued their recovery from their turn-of-the-year sell-off as heightened political uncertainty globally raised demand for so-called safe-haven assets. The main factor pushing bond yields lower (and therefore prices higher) was political turmoil in Italy in the wake of the success of populist, anti-EU parties in May's elections. For the broader Eurozone market, the main development was the announcement by the European Central Bank of the winding up of its quantitative easing programme in December. It was a mixed quarter for the US Treasury market. Initially, strong growth data depressed the market and pushed the yield on the benchmark ten-year issue above the psychological 3.0% level in mid-May. Thereafter, however, the market recouped most of its losses as investors sought security in the face of escalating trade war concerns. This came despite rising expectations that the US Federal Reserve would need to accelerate rate hikes given rising inflation and a strong jobs market.

PORTFOLIO COMMENTARY

In the second quarter of 2018 the portfolio returned 0.43% which was 8bps less than the FTSE Canada Universe Bond Index returns. Index returns were driven mainly from yield and roll down which were offset by a bear flattening in the rates market and wider corporate and provincial spreads. Wider corporate spreads were the main detractor of performance versus the index. Fears surrounding both implemented tariffs and the threat of new tariffs continued to rattle the fixed income markets. Towards the end of the quarter the market tone was calmer as the US economy continued its pace of strong growth. The Canadian economy continued to grow at a decent pace with higher oil prices, a lower Canadian dollar, and healthy business investment offsetting a slowdown in consumer spending from tighter mortgage rules and higher interest rates.

Global growth is expected to remain strong led by the United States as a result of tax cuts and increased fiscal spending. However, while the immediate impact of implemented tariffs is expected to be small the threat of further tariffs could have major implications for future growth and business uncertainty could reduce global spending. Additionally, the strength of economic growth will be tested by central banks that are expected to end quantitative easing programs and increase interest rates.

With Canadian unemployment at 40 year lows we expect tightening labour markets will cause increased inflation in the Canadian economy. As inflation pressures come through, the Bank of Canada will likely continue on its gradual pace of tightening. However, due to high levels of consumer leverage and sensitivity to higher interest rates the tightening cycle will likely have a shorter duration than in the past. We are moderately constructive on the fundamentals of the Canadian investment grade credit market due to our base case view of strong and stable corporate fundamentals and an improving economy. However, tight credit spreads compared to historical levels, stretched household balance sheets, rising protectionism and the impact of higher interest rates could all have the potential to widen spreads further.

During the quarter we reduced our exposure to long-end provincial bonds due to downside risks to spreads if deficits continue to increase. Concurrently, we increased exposure to shorter-dated corporate bonds where carry and rolldown remain attractive and offer downside protection versus long-dated bonds. We also took advantage of a number of idiosyncratic opportunities where return potential and downside protection were solidly in our favour.