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38 Years Old, Never Kissed a Bond Bear

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North American long-term government bond yields hit their all-time high on September 30, 1981, with the 10-year Treasury topping out at 15.84% and Canadian yields of 10 years and over maxing out at 18.14% that same day. It's pretty much been all downhill for yields since that point. While it would be an exaggeration to say that the bond bull has been consistently charging through that entire period, anyone now in their 38th year (or younger) would have never experienced a true bear market in bonds. Oh, there were some serious years of sell-offs—1983, 1987, 1994, 1999, 2009 and 2013 all saw 10-year yields rise by more than 100 bps—but the mega downtrend was never seriously challenged. Until now.

It's been highly dangerous to declare the bond bull dead for decades now, with many pundits humbled by prematurely opining on its demise. But the sustained nature of the back-up from the record lows of two years ago, and the clear risk of more, makes this episode different. This week saw old resistance levels crack, as the benchmark 10-year Treasury jumped 17 bps to over 3.2%, hitting its highest level since the Spring of 2011. A big chunk of the curve vaulted above the 3% threshold, with 5-years joining in and thus hitting their highest level since pre-Lehman days of a decade ago.

The latest rise in yields was driven by a combination of **robust U.S. economic data, fresh highs for U.S. equities, and four-year highs on oil prices**. True, each of these factors took a step back late in the week—September payrolls were nothing special at +134,000, stocks stumbled, as did oil—but the big picture very much stayed in place. Loaded on top of a robust economy, Fed Chair Powell chimed in a few times this week with a hawkish message, notably that policy could easily be driven above neutral (i.e., fed funds above 3%). In addition, there's the increasingly ugly supply side of the equation, with Washington staring down a $1 trillion budget deficit this fiscal year (which started Monday) and the Fed now hitting its maximum stride in quantitative tightening.

The **rest of the world was not spared** from the back-up in yields. While the Italian budget machinations provided some drama in Europe, yields pushed higher around the continent, with even bunds rising 10 bps to 57 bps. But **one of the biggest jumps in yields was seen in Canada**. After hitting an all-time low of 0.95% just a little more than two years ago, 10-year GoCs have since vaulted 165 bps to 2.60%, with 17 bps added in just the past week alone. The USMCA deal sparked the initial selling wave—washing away the biggest source of uncertainty for Canada, and thus ramping up BoC tightening odds across the board—but the Treasury sell-off piled on.

Domestic factors certainly support the back-up in Canadian yields. Employment was solid in September (+63,300, jobless rate down a tick to 5.9%), trade posted its first surplus in almost two years, and forecasters busily revised up their 2019 growth projections on the relief of the USMCA and the just-announced $40 billion LNG project in British Columbia. Given that the risks to Canadian growth forecasts are now to the upside, headline and core CPI are basically in sync with U.S. trends, and

global oil prices are rising (WTI at $75), it's increasingly tough to justify the meaty U.S.-Canada bond yield spreads (now 63 bps for 10s and a honking 82 bps for 30s). While a better fiscal position can partly support that gap, we believe the trend will be toward a narrower spread over the next year—in other words, Canada is now looking to venture much deeper into bear country.

While Canada's rate structure and outlook were shifted heavily by the trade deal, other domestic markets moved on with pace. A staggering piece of trivia—no doubt to be hauled out in the years to come—is that the Canadian dollar actually fell and the TSX was actually down for this week (-1.0% as this is written). That's in a week when oil was strong, jobs were solid, the LNG project advanced and a North American trade deal was secured. Of course, a major caveat is that Canadian oil prices are reeling, with the WTI-WCS spread reaching a record high of over US$40. Still, imagine where we would be on the loonie and stocks if the economic and trade news was bad!

Sometimes in the forecasting business you just have to admit that reality is diverging significantly from what you projected—i.e., you were wrong. Some broad samples (not from us, mind you) would include: "It's different this time"; "an inverted yield curve is due to special factors and doesn't mean much"; "Clinton in 2016"; "U.K. Remain in 2016"; "the Leafs will win in pick-a-year-since-1967"; and "the Bank can't possibly hike for a second consecutive meeting with no communications". Adding to the list, a week ago we opined: *"Absent a last-minute miracle, it looks like lengthy NAFTA negotiations will blow through yet another supposed deadline this weekend."*

Well, the ground appeared to shift almost the moment that the ink on the quill was hitting the paper on Friday. It was announced later that day that the Mexico-U.S. deal was not going to Congress after all, and the incoming Mexican President (AMLO) again stressed that any deal should include Canada. Beyond the keen eye of the media, intense negotiations were going on all the while, and the real horse-trading over the weekend began. So, miracles do apparently happen. Curiously, Friday was the same day that the passing of Marty Balin, co-founder of **Jefferson Airplane** (later Starship), was announced. How in the world does this pertain to NAFTA? Balin may be best known for his great comeback song with Jefferson Starship, the 1975 gem "Miracles".

Coda: Concluding the Joe DiMaggio/NAFTA allegory of two weeks ago, Joe eventually did come to terms with the Yanks just in time for the World Series, but at a 5% pay cut, versus George's demands for a 20% reduction. And, yes, Marilyn will agree to a glass of 3½% milk, as well as a chicken and cheese omelette with George. Two small surprises in the new contract—no fraternizing allowed by either Joe or Mickey Mantle with that upstart Reggie Jackson, and Joe will have to go back to watching the Canadian commercials during the Super Bowl. And how those two particular items ever made it into contract talks is beyond me as well.

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