# Quarterly Commentary

## Mackenzie Fixed Income Team

June 30, 2020

For most, the second quarter of 2020 will be remembered as a truly challenging, transitional time for our society and economy. The peak (or trough as-it-were) of the Covid crisis likely occurred in April of 2020 to kick off the quarter with many workers – those who were fortunate to keep their jobs – transitioning to a work from home environment for what seemed at the time to be months, if not quarters or longer.

From a markets perspective the challenge for many in Q2 was that risk assets continued to seemingly head in one direction – higher – perplexing many in the industry (ourselves included) on how those assets could be consistently rising in a time of great global crisis, massive unemployment and plunging output and consumption.

A few factors were at play – some obvious and some less so. First, obviously global central banks which had come in at the end of Q1 continued to provide liquidity, various quantitative easing measures and various programs to help backstop various asset classes. Here, the Fed's corporate bond program initiative seemed to have an outsized impact for market sentiment. Second and less obvious, as we moved throughout April and May we got more information about the retail investor, who for some in the absence of working, little in the way of new live sporting events and in many cases an increased overall paycheck from not only standard unemployment but also the federal stipends, had begun dabbling in the equity market for the first time and in size – almost no matter what the fundamental news suggested. And a third which was somewhere in the middle were some economic numbers, particularly on the job front, but also on the ISM / PMI side suggesting a "rebound" that looked more "V-shaped" than what had initially been expected although this continues to be open to interpretation.

Fixed income markets, however, behaved somewhat differently, keeping more of an eye on what we would label as the medium-term fundamental outlook; with the exception of a quick blip higher in early June, US 10-year Treasuries generally traded in a 60-75bp range for the quarter while the Canadian 10-year had a little more volatility but generally kept a similar pattern. Talk in the US of "negative rates" was a large driver for a while for the short-end of the curve although Chairman Powell and the Fed at large continued to push back and yield curve control as a serious policy tool became more of a discussion point (we believe the latter or a variation thereof like yield caps is more likely than the former).

Going forward we believe uncertainty persists for the virus and by extension global markets and believe that fundamentals will – eventually – come back to be the main driver of assets. The recent news out of the southern and western US is disconcerting to say the least, particularly when juxtaposed with the general thought in March and April that warmer weather was or would supress the virus. These flareups are likely to continue in the quarters ahead – until there is a vaccine and it is properly distributed. And so this "stop-start-stop" pattern in terms of the economy and society reopening is likely to be with us for a while. This is going to make it difficult to get a gauge on exactly where things are at, but one thing is for certain: the economy – whether that is Canada, the US or globally – is going to be below its nominal capacity for a long time, likely years as a result of what has happened in the first-half of 2020.

For fixed income markets this likely means the grab for yield will continue and any "pop" that we see (note the longer-end of the US curve in early June) will be met with demand. What will be interesting for us will be to see how the inflation picture develops; our initial view was that a deflationary environment was likely to take hold for a while and we still think there is downwards price pressure overall. However, we also believe there is a rotation in consumer consumption patterns occurring behind the scene whereby some goods and services are seeing massive price devaluations (hotel rooms or dry cleaning), but others that are more in demand (exercise equipment and home office furniture) are seeing higher price pressures. How that change in the consumption basket impacts overall inflation is going to be an important driver in how the longer-end of the curve performs over time as we move through this pandemic.

Finally, we are less than four months away from the US election and the Covid crisis has completely upended the Presidential race. Pre-Covid, Trump's economy was doing well and the election looked to be his to loose. But Trump's perceived handling of the Covid crisis has impacted his approval levels and, critically, his levels in the Midwest and suburban voters. And while polls are not everything, at the state level Trump is trailing former Vice President Biden in many of the key swing states like Michigan, Wisconsin and Pennsylvania. Moreover, the race looks like a toss-up in vote-rich Florida while Arizona looks to also be flipping to Biden. And Texas, once thought of as a safe "red state" is now looking a lot more purple.

While a Biden presidency is probably not "bad" for risk appetite per se, a Democratic sweep probably has an impact from current levels. Here too, where it looked to be "safe" for Republicans to hold the Senate earlier this year, now looks to be a very close call. Democrats need a net four seats to gain control of the Senate and as we go to press they are currently up in six. A Democratic sweep likely means a higher probably of rolling back some of Trump's tax reforms, particularly corporate taxes, now 21%, to 25-28%, a very green agenda and unwinding a lot of the financial deregulation this administration and Fed have done since 2017. To us, financials and the energy sector seem to be most at risk on a "surprise" Democratic sweep from a macro perspective and while the election is not until Q4, we anticipate it to be a growing Q3 theme.

Taking all into account, this probably means familiar ranges for the Canadian and US curves with a continued bias towards the downside with the front end, particularly in the US capped.