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*As we noted in our last communication (December 2018), capital markets were challenging through 2018 especially in the last quarter. And yet both equity and bond markets roared back in the first quarter of 2019. In the second of our two-part communication with you, we asked **Addenda Capital Management**, the investment sub-adviser for the **Social Housing Short Term Canadian Bond Fund and the Social Housing Canadian Bond Fund**, to comment on the drivers of returns for bond investors, commentary on the credit crisis, and their outlook for fixed income markets in 2019.*

Bond Market Primer

Bonds appear to be simple investments but the dynamics surrounding bonds and, in particular, the pricing of bonds, are quite complex as markets and the economy change overtime.

A bond is an obligation to pay a fixed rate of interest (the coupon rate) over a specified period of time and to repay the face/par value of the bond (the principal) at maturity. Various factors are considered when establishing the coupon rate at the time a bond is issued, including the prevailing market level of interest rates, the credit rating of the issuer and any other factor that would indicate the issuer's credit worthiness.

A bond is issued by a government or corporate issuer usually when there is a need for funds. Given the legal requirements and the costs to issue a bond (i.e. the prospectus, distribution fees, etc.), bonds are usually issued in large bulk sums ($100 million up to $10 billion). Each bond in the issue will have a par value that is usually $1000 or $100.

The complexity of bonds as an investment arises when market interest rates change, as they do frequently, or when credit fundamentals change for the issuer (less frequently) or in the market (rare - such as the 2008 Credit Crisis).

They key to understanding the return from bonds is to remember that a bond's coupon rate does not change. That is the amount of interest paid remains the same.

An example of bond pricing when market interest rates change:

> A high quality (AAA-rated) 10-year Canada bond issued in today's market will have a par price of $100 and a coupon rate of 2.20%.
>
> If interest rates move up to 2.30% two weeks after the issuance, that 2.20% coupon bond will be worth less than new bonds being issued at the new level (2.30%). As a result, the price of the 2.20% coupon bond will decrease as it is deemed to be not as attractive as a 2.30% coupon bond.
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> The bond holder who plans to hold the bond to maturity won't care about the price decline. But most bonds are marked-to-market (unlike GICs) which simply means that the price or market

value of the bond moves with changes in interest rates. If the holder rather than holding to maturity decides to sell the bond before it matures, it will be sold at the market rate (which is lower), not for par value (or its original price).

If the level of market interest rates were to fall to 2.10% below the bonds coupon rate of 2.20%, the inverse will occur and the price of the bond will appreciate. The market price of the bond rises higher than the par value because the original coupon rate is better than market rates available at that time.

In practical terms these two examples demonstrate that there is an inverse relationship between the yield of the bond and its price in order to hold the coupon rate constant.

As a bond approaches maturity, the market price of the bond will move closer to par value until at maturity the market price equals its par value. If an issuer's credit deteriorates significantly, the market price of their bonds will fall because buyers may have less faith in the issuer's ability to pay the coupon or, even worse, the principal on the loan. Market conditions and particularly liquidity (the number of buyers versus sellers) can also impact the market price of bonds.

2008 Credit Crisis and Its Impact on Interest Rates

Prior to the credit crisis in 2008, we were in a period of unprecedented low interest rates and low credit spreads (low credit spreads mean investors require less extra compensation for taking on more risk). But as the credit crisis unfolded, liquidity (the number of buyers and sellers) dried up and both market and specific issuer credit risk (credit spreads) soared. The U.S. Federal Reserve (the 'Fed') responded to the crisis by moving its bell-weather Federal Funds Rate down to 0% with most other central banks following in the same direction. For example, the Bank of Canada (BOC)'s Target Rate hit a low of 0.25% in early 2009. Short-interest rates in any market generally follow the rates set by the central bank. Accordingly, short rates declined in 2009 to lows not seen since the 1930's. This process is referred to as "monetary easing".

The Fed's intent with its aggressive monetary easing was to stabilize the markets and the economy by providing liquidity and confidence. The Fed also added mortgage and bond buying programs, which were adopted by other countries but was not deemed necessary in Canada.

As we now know, these (unprecedented) monetary policies were eventually successful although it took close to a decade for the global economy to regain a solid economic footing after the crisis. Accordingly, it wasn't until late 2016 that the Fed started to raise the Fed Funds Rates when they began to sense that the U.S. economy and financial markets were no longer vulnerable. In contrast, the BoC had raised their Target Rate to 1.00% earlier in 2010, but were forced to cut it back to 0.50% in 2015 as the economy (commodities specifically) faltered. It wasn't until mid-2017 that the BoC was able to begin raising rates again. As the global economy gained momentum in synchronized fashion through 2017, more central banks followed the Fed by reducing excess liquidity in their respective bond markets. This stage of the central bank tightening process (i.e. raising of rates) was intended to move rates back to a neutral point as the global economies stabilized. Throughout this period, inflation remained relatively benign, but in

2018 there were some signs of rising inflation, the signal for central bank to raise rates further – to truly tighten, not just to bring rates back to more normal levels.

Monetary Policy Direction and Market and Economic Outlook

The central question today is – *has the period of monetary easing come to an end*?

In our view the answer is a definitive yes. All central banks have been trying to reduce the excess liquidity that was introduced to combat the prior decade's credit crisis.

The more profound question at this point is - *where do interest rates go from here?*

It would take a global recession to push the central banks back into easing mode. We at Addenda do not see a recession on the horizon. The current U.S. Fed Funds Rate is a range of 2.25% - 2.50% and the BoC's Target rate is at 1.75%. (There is always an inflection point at which rising rates will choke off economic growth.)

The debate surrounding tightening - *what is the neutral point? are high rates choking off growth?* and *what is the long-term inflation risk?* - were among the factors causing the equity correction in the last quarter of 2018.

High equity valuations, fading fiscal stimulus (there is nothing replacing the prior year's tax cuts and deregulation that stimulated U.S. growth), Trump's aggressive trade policy, slowing global growth because of this trade policy, political events (the U.S. election and populism gaining favour) and other geopolitical events also contributed to the equity correction.

The bond market did better in the fourth quarter because of the realization by investors that further rate hikes from the central banks were less likely.

Addenda believes that the Fed and the BoC will pause before continuing down the path of raising rates. We believe that future hikes will be data dependent, meaning that either economic growth regains momentum or inflation flares up. We are in the camp of seeing the latter happening. There is still a chance of further hikes later in 2019 if the U.S. and China resolve their trade differences and if the recent economic slowdown proves to be temporary. In Canada, we are inextricably tied to commodities and there are developments occurring, notably demand/supply imbalances being slowly resolved, that might bring a more promising outlook for our resource sectors.

It is worth noting that bonds and stocks compete for funds. After many quarters of equities winning this 'flow of funds' competition, it was abruptly reversed in the fourth quarter of 2018. The bond market benefitted as a place of safety with the freefall in stock prices. We are under no disillusion that the competition will get tougher as stocks gradually rebound in 2019.

Addenda is forecasting a 2% total return for the FTSE Canada Universe Bond Index in 2019 year, as well as 6% for the S&P/TSX Composite, 5.0% for the S&P 500 Index (CA$) and 4% for the MSCI EAFE Index. The volatility in all markets has increased and will likely continue through the year. Credit spreads,

which widened out in the fourth quarter in concert with the equity correction, should narrow modestly in 2019 for the Canadian bond market. Inflation will not be a problem in the coming year, which relieves some pressure on the longer end of the yield curve while short-rates could still see some upward pressure if central bank tightening resumes later in 2019.

We hope you have enjoyed these market commentaries from the Social Housing Fund sub advisors. We intend to communicate with you on a regular basis and will look forward to your comments and suggestions for future briefings.

Encasa Financial Inc.

Sincerely,

Derek Ballantyne
Chief Executive Officer,
Encasa Financial Inc.

Addenda Capital is a 33-year old firm managing $27 billion in AUM with offices in Montreal, Guelph, Toronto and Regina and a total staff of 125. Addenda manages pension, private wealth, insurance, corporate and foundation assets principally for Canadian clients and is focused strictly on asset management – it does not distribute mutual funds or have complex banking interconnections. Their ownership is simple with The Co-operators having the bulk of the shares and staff owning the rest.

Addenda has a long history of bond management with the expertise and scale that Encasa requires. Addenda manages $18.8 billion in fixed income assets (70% of their total AUM) and has 23 experienced fixed income investment professionals making it one of the larger non-bank active bond managers in the market. The Addenda team managing the Short term Bond Fund and the Canadian Bond Fund are a stable team that has been working together for many years.