Vancity Investment Management

RESPONSIBLE INVESTING NEWSLETTER – FEBRUARY 2018

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Building safety in Bangladesh: More work to be done

Workers in the garment industry have historically faced harsh working conditions, low pay rates, tenuous job security and unsafe environments. When mass clothing manufacturing emerged in British cities during the industrial revolution, crusading journalists and public advocates identified child labour, excessively long hours and low pay as commonplace throughout the industry. The term "sweatshop" was coined to describe these workshops and factories. Workforce unionization and a series of jobsite disasters led to improved conditions and new rules and regulations. In particular, the Triangle Shirtwaist Fire of March 25, 1911, in which 146 garment workers died, led the New York Factory Investigative Commission to propose 36 labour bills and numerous safety regulations, which were adopted by the legislature.

Over the last 25 years, most of the garment manufacturing industry has relocated to developing countries, while consumption remains dominated by retail customers in the developed world. Clothes are designed and marketed by brands based in North America and Europe, but are rarely produced where they are sold. Although production has shifted, adequate labour protections, along with health and safety regulations, have yet to be effectively implemented. Nowhere is this more apparent than in Bangladesh. On April 24, 2013, the collapse of Rana Plaza, a multi-purpose building that included a garment manufacturer, resulted in 1,100 deaths and 2,600 severely injured workers.

Following the Rana Plaza tragedy, a group of clothing retailers and international unions developed a legally binding, five-year agreement: the Accord on Fire and Building Safety in Bangladesh. The purpose of the Accord was to ensure manufacturers who produce goods for these retailers operate factories that are compliant with fire and safety codes and practices. The Accord hired and trained staff in Bangladesh to conduct independent safety inspections and provide a funding mechanism to support remediation efforts of non-compliant factories. To date, 127 factories have fully completed initial remediation, 700 factories have completed 90% of their remediation plans and 773 factories have mitigated 82% of the identified safety issues.

In addition, the Accord developed a safety committee training program. Approximately 850 committees have enrolled, with over 1.2 million workers receiving training. The Accord, signed by 220 companies, is due to end in May 2018. In June 2017, several companies and global unions agreed to extend the Accord for an additional three years to ensure adequate time to remediate problems identified at supplier factories in Bangladesh and to transition the inspection program to local regulators. Sixty companies have signed the new agreement, including Inditex SA (IA Clarington Inhance Global Equity SRI Class) and Loblaw Companies (IA Clarington Inhance Bond SRI Fund, IA Clarington Inhance Monthly Income SRI Fund and IA Clarington Inhance SRI Portfolios).

In addition to the Accord, 29 retailers developed a parallel program: the Alliance for Bangladesh Worker Safety. To date, 300 of 658 factories used by Alliance retailers have completed remediation, and 85% of identified actions have been completed across all factories. Over 1.3 million workers and 20,000 security guards have received fire safety training. In

2018, the Alliance is scheduled to disband and immediately transition its program to local partners. Two companies we hold are members of the Alliance: Canadian Tire (IA Clarington Inhance Canadian Equity SRI Class) and Costco (IA Clarington Inhance Global Equity SRI Class).

We joined the Bangladesh Investor Initiative in May 2013 to encourage companies held in the IA Clarington Inhance SRI Funds to join the Accord. The initiative includes 147 institutional investors who believe the Accord provides increased certainty that worker safety and the right to a respectful workplace will be protected. Based on our analysis of the most recent reports by the Accord and the Alliance, we believe there is much more work to be done before either program ends. We are encouraged that the Accord is being extended and are now advocating for Canadian Tire and Costco to join the new Accord in support of the three-year transition.

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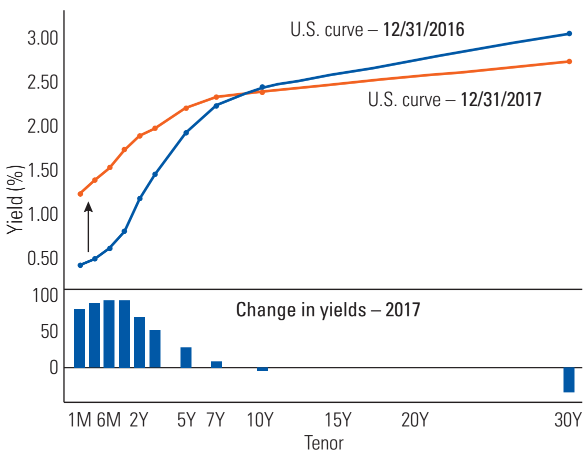
Interpreting a flatter yield curve

A flattening yield curve has historically signaled a slowing economy. But today's flatter curve is unlikely to fit this pattern. Let's look at why.

YIELD CURVE CHANGE IN 2017

The U.S. yield curve flattened dramatically in 2017. By year-end, yields in the front end of the curve rose more than 75 basis points compared to the end of 2016, while yields in the long end fell more than 30 basis points (Figure 1).

Figure 1: U.S. yield curve and change in yields

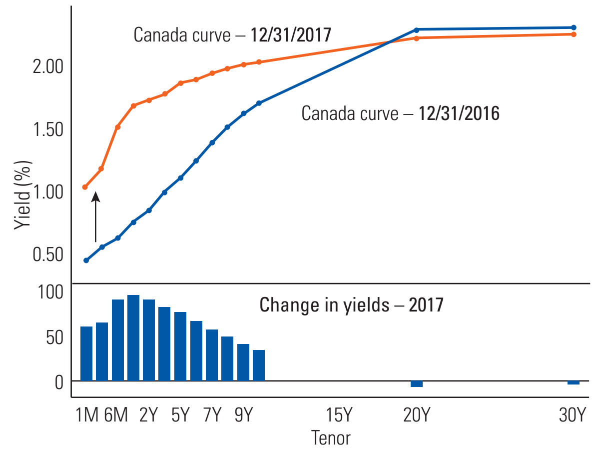


Source: Bloomberg.

Driving the increase in the front end was the U.S. Federal Reserve (Fed), which raised the federal funds rate three times in 2017. The spread between the 10-year yield and the 2-year yield, known as the 2s10s spread, ended 2017 at 52 basis points, down from 126 basis points at the start of the year.

In Canada, yield curve flattening was not as pronounced. Yields in the front end of the curve rose slightly more than 50 basis points (compared to more than 75 basis points in the U.S.). This increase was driven by two Bank of Canada rate hikes over the course of 2017. Yields in the long end of the curve did not drop nearly as much as they did in the United States (Figure 2).

Figure 2: Canada yield curve and change in yields



Source: Bloomberg.

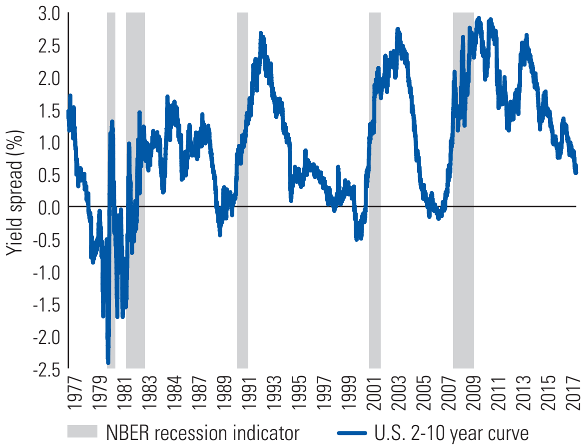
Canada's 2s10s spread ended 2017 at 36 basis, down from 97 basis points at the start of the year.

YIELD CURVE AS RECESSION INDICATOR

Historically, the yield curve flattens as an economic expansion ages and the Fed raises rates to prevent the economy from overheating. As rates go up, short-term bonds yields rise and the curve tends to flatten. The 2s10s spread is a common measure of yield curve steepness and is widely seen as the most reliable recession indicator available.

Looking at U.S. historical data, which is more readily available than Canadian data, the 2s10s spread has turned negative (denoting an inverted yield curve) prior to every U.S. recession over the past 50 years:

Figure 3: U.S. 2s10s spread (percentage points)
(December 1977-December 2017)



Source: Bloomberg. Shading denotes periods of U.S. recession as defined by the National Bureau of Economic Research (NBER).

While the 2s10s spread appears to have a reliable track record as a leading indicator, there are a few points to note from the chart above:

- Although every U.S. recession over the past 50 years has been preceded by an inverted yield curve, not every yield curve inversion has been followed by a U.S. recession (e.g., the brief inversion in 1998)
- The 2s10s spread can stay flat for an extended period without a recession (e.g. 1994–1999)
- The lead time from yield curve inversion to the start of the next recession can vary greatly and has ranged from 1.2 to 2.0 years for the past three recessions:

Recent U.S. yield curve inversions and subsequent recessions

Recession	Curve inverts*	Recession starts**	Lead time (years)
Savings and loan crisis	Dec. 1988	Jul. 1990	1.6
Dot-com bubble	Feb. 2000	Mar. 2001	1.2
Global financial crisis	Dec. 2005	Dec. 2007	2.0

*Curve inversion refers to the spread between the U.S. 10-year and 2-year yields turning negative.

**Recession start date based on National Bureau of Economic Research (NBER) definition.

In addition to these caveats, there are at least two factors that have changed this cycle that could be distorting the yield curve and hence the predictive value of the 2s10s spread. These factors have generally pushed long bond yields lower, making the yield curve flatter than it would otherwise be.

1. Quantitative easing

The Fed expanded its balance sheet significantly since the global financial crisis, buying Treasuries and mortgage-backed securities as part of its quantitative easing programs, which were designed to keep bond yields lower than they would otherwise be. While the Fed ended its last quantitative easing program in 2014, the sizeable Treasury holdings on its balance sheet, which skew to longer-term maturities, will continue to keep the yield curve flatter.

More recently, a number of other Central Banks, including the Bank of England, the European Central Bank and the Bank of Japan, have also engaged in their own quantitative easing programs designed to keep bond yields lower. Given the interrelatedness of financial markets, these quantitative easing programs have no doubt exerted downward pressure on global bond yields.

2. Declining neutral interest rate

The neutral interest rate is an interest rate level that is neither stimulative nor restrictive on economic activity. This rate has likely trended lower across the globe in recent years amid lower productivity growth and aging populations in developed countries. The Fed's estimated longer-run federal funds rate was 2.75% at its December 2017 meeting, down sharply from 4.25% in January 2012, when the Fed first began publishing its "dot plot" rate forecasts. Since longer-term yields partially reflect expectations of future short-term rates, it's no surprise that long-term yields have come down with the lower neutral interest rate.

CONCLUSION

An imminent economic slowdown does not appear likely. While the yield curve has flattened significantly since the start of 2017 (and been in a general downtrend since 2013), the 2s10s spread remains a fair distance away from inverting. This, combined with central bank interventions and the long lead times between yield curve inversions and subsequent recessions, appears to suggest the current economic cycle still has room to run.

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DEFINITION OF TERMS

Basis point – One one-hundredth of one percent (0.01%).

Dot plot – Represents the long-term interest rate projections of members of the U.S. Federal Reserve's Federal Open Market Committee.

Federal funds rate – Refers to the interest rate set by the U.S. Federal Reserve.

Institutional investors – Large investors, such as pension funds, banks, mutual funds, foundations and endowments.

Inverted yield curve – Represents market conditions in which long-term debt instruments have lower yields than short-term debt instruments.

Mortgage-backed securities – A security backed by mortgages on residential properties.

Quantitative easing – An unconventional monetary policy tool used by central banks that involves purchasing securities from the open market in an effort to lower interest rates and stimulate the economy.

Spread – The yield difference between two types of bond, typically expressed in percentage points or basis points.

Tenor – The length of time before a bond matures.

Treasuries – Debt instruments issued by the U.S. government with fixed interest rates and maturities that range from one to 10 years.

Yield – The amount earned from a fixed-income security.

Yield curve – Graphically illustrates the yields and maturities of bonds of similar credit quality. A normal yield curve slopes upwards (i.e. bond yields rise as maturities lengthen).