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COUNSEL INC.

Market Highlights

Canadian 10-year and long bond yields fell 8 and 7 basis points respectively in July, while in the US 10-year yields were higher by 4 bps and long bond yields fell by 2. Short term yields were stable in both Canada and the US resulting in relative flattening of the, already much flatter, Canadian yield curve. Weaker employment data and a more restrained outlook from the Bank of Canada encouraged the Canadian move. While in the US, longer rates were volatile due to a mix of generally stronger data (except for housing) amidst a host of global factors which significantly affected Treasury flows.

We would have anticipated a more substantial rise of US yields over the month, given the positive data and the potential for an accelerated timetable for monetary tightening. However, a variety of non-economic factors continued to have significant market impact including escalation of both, the Russia-Ukraine and the Israel-Hamas conflicts, frothy US equity markets and ultra-low European bond yields, not to mention declining US financing requirements.

In Canada, the economy presented a mixture of data in July. June's trade numbers were poor on the back of disappointing manufacturing exports. However, July's data, just released, show some rebound, although largely from higher commodity prices. Housing data continued to be mixed with permits and starts both surprising to the upside, while existing home sales were largely disappointing. The major real estate markets of Toronto, Calgary and Vancouver continued to hold up relatively well, while the situation in the rest of the country appeared more tepid.

Inflation has been mostly benign in both Canada and the US with core CPI hovering around 1.9% in both countries. Canadian investors seemed relatively sanguine about inflation, with 10-year inflation expectations (as described by the spread between 10-year nominal and real return bonds) at 1.9%, compared to US investors, where expectations (as

Focused Fixed Income

described by the spread between 10-year nominal bonds and TIPS) are at 2.3%. Although headline inflation expectations have been higher in Canada than in the US, the Bank of Canada has gone to great lengths, particularly in July's Monetary Policy Report, to emphasize the transient nature of current inflation, highlighting the depreciation of the Canadian dollar and the concomitant rise in commodity prices. Recent US economic data has also been more robust than the Canadian data with US payrolls appearing noticeably stronger. Finally, although wages have yet to turn up in either country, the greater prospects for US wage growth will have also likely contributed to the higher inflation expectations south of the border.

Outlook & Strategy

We are of the opinion that we will begin to see some wage increases in pockets of the US labour market. Although many of the job gains have been in the lowest wage parts of the economy – hospitality and retail, the tightest labour markets are in some of the highest wage parts of the economy – management, professional, and related occupations, as well as skilled workers in mining, oil, and gas. Canada may experience wage growth in some sectors with tighter labour markets as in the US, but given the weakness in some important sectors of the Canadian economy, such as manufacturing, we don't expect to see the same overall wage pressures as in the US. Ultimately, some US wage growth will likely push US yields higher, also dragging Canadian yields higher in the process, albeit to a lesser degree. Given the dovish stances of the US and Canadian central banks, we would expect yield curves to steepen first, followed by flattening further out as monetary policy adjusts. Currently, it is our opinion that investors have not adequately priced in a reasonable probability of US monetary tightening in the belief that either the US economy or other external factors will keep policy loose. However, we are not convinced; although for the moment, we appreciate the impact that global factors are having on the US, and indirectly Canadian yield curves.

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