April 30, 2015

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

10-Year US Treasuries spent the first half of April in a narrow range just below 2%, leading many investors to believe that Treasury bonds had found a new comfort level, consistent with a Fed that would remain on hold for longer than previously assumed. The Fed supported this contention with its April FOMC policy statement that focused on the slowing economy during the winter, albeit highlighting the effects of “transitory factors”. Many market commentators interpreted the Fed’s communication as indicating a June hike would be unlikely, with September a possibility [given the time for signs of stable growth]. However, data released in the second half of April have revealed signs of a nascent recovery, leading investors to push longer term yields higher into month end, steepening the US Treasury curve in the process. During the month, ten year Treasuries went from 1.94% to 2.04%, while two years were virtually unchanged, and the 2-30’s curve steepened from 197 to 215 basis points.

The long end of the Canadian bond market followed a similar trajectory to that of the US, with 10-year Government of Canada yields rising from 137 basis points to 159, with the move taking place in the second half of the month. However, the short end of the Canadian bond market behaved quite differently, as investors responded to Governor Poloz’s statements following the release of the Bank of Canada’s April policy statement and MPR, indicating that he was satisfied with the current amount of policy stimulus. Investors have had to contend with inconsistent messaging from the Governor since the overnight rate was raised in January, which has caused significant volatility to short term rates. While the Treasury curve steepened in April, the Government of Canada curve was relatively stable, going from 148 bps to 150 bps – 2-30’s.

Bond markets continued to be impacted in April by the relentless demand for duration that has been fueled by central bank quantitative easing programs. The ECB is the prime culprit at the moment with its program to purchase €60 billion in European sovereign and agency debt per month. European sovereign yields have correspondingly fallen precipitously, with negative yields along many yield curves in Germany, Switzerland, and Denmark for maturities as long as 10 years. The incessant demand for high quality debt has translated into demand in other markets, including the Treasury and Government of Canada markets. There was a notable rise in bond yields in late April as European economic data showed some signs of improvement, but there is no evidence, at this time, that the ECB will curtail its asset purchases prematurely, which should keep a lid on any increases.

Demand for corporate bonds was solid during the month, with investors focused on corporates as a source of alpha, but hesitant to extend into longer duration or higher beta credit. Issuance was concentrated in shorter-tem maturities, much of it financial in nature, and amounted to $4.3 billion. Yield spreads tightened by an average of 2 basis points, with the best performance coming from the mid-term area of the yield curve.

Outlook & Strategy

We fully expect the negative economic factors seen in the winter (weather and oil prices) to dissipate into the spring leading up to better growth in the summer and fall. The Fed has indicated its desire to begin raising rates and we expect it to follow through with its intentions in Q3, although cautiously. The US yield curve will move higher with a flattening bias. The Bank of Canada should remain on the sidelines, but what will actually happen is anybody’s guess – we doubt an increase is in the cards. Longer term Government of Canada’s will likely track Treasuries while short term yields should remain stable. We are comfortable with the portfolio's relatively short duration and overweight position in credit.

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