August 31, 2015

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Volatility dominated world markets in August, with the Canadian and US bond markets being no exceptions. The confluence of the Fed's impending rate decision in September, unstable oil prices, Chinese stock market declines and insufficient market liquidity generated significant market volatility, most notably for riskier assets. During the month US equities declined by -6.03% (S&P 500 Total Return Index), turning 2015 returns negative, while lower rated US corporate bond yield spreads widened by 21 basis points (Moody's Seasoned Baa Corporate Bond Yield Relative to 10-Year Treasury Constant Maturity Yield). The Canadian equity market was less severely impacted during the month, falling -4.04% (S&P TSX Total Return), having already fallen earlier in the year due to its heavy exposure to the energy sector. Canadian corporate yield spreads widened by 11 bps (FTSE TMX Canadian Bond Universe Mid Corporate Bond Index) in August, owing to the benchmark's relatively higher quality.

Government bonds were also not spared the volatility during August, but did not display the same kind of directionality as other assets. 10-Year US Treasuries yields were virtually unchanged over the month, but declined by as much as 20 bps at one point. Government of Canada yields were similarly volatile, although ending the month slightly higher by 4 bps for 10-years bonds.

While there were a host of factors impacting the markets, these factors seemed to be evaluated more for their effect on the Fed's September decision than on their underlying impact on the fundamentals of the economy. Although the Fed has made it clear that its decision to raise interest rates will be data dependent, which implies some relationship to fundamentals, no-one seems to have a good handle on what data dependence actually means. Consequently investors have been left guessing as to the Fed's sensitivity to factors such as general capital market stability, growth outside the US and energy prices which have reduced their willingness to hold on to riskier assets. After years of QE and zero interest rate policies, sensitivity to a change in policy is now relatively acute. Furthermore, in terms of the bond market, the change in dynamics of market liquidity that has evolved since the credit crisis has amplified the markets response to investor activity.

In Canada, economic data released during August continued to paint a troubling picture of the domestic economy. Although it will take time to conclude whether the economy was technically in recession in H1, Q1 and Q2 growth were both negative at -0.2% and -0.1% respectively. Employment has not grown noticeably this year and the unemployment rate has ticked up, however, the labour force data offered a slight glimmer for optimism, indicating that some workers have shifted from part time to full time work. The one bright light in the data has been the reduction in Canada's trade balance, led by an increase in non-energy exports.

Finally, with the environment for corporate bonds waning, the new issue market all but stalled in August. A paltry $700 million of fixed rate deals came to market in Canada, well off the monthly average of $7.9 billion recorded to the end of July. Although new issues were offered with generous spread concessions, they were generally thinly subscribed and traded at wider levels relative to where they were initially priced.

Outlook & Strategy

We believe the Fed is still on track for a September rate hike, noting that last month we said that they would only be deterred if August's employment report surprised significantly on the downside, which in our view, it has not. (The August report showed an undersized gain of 173,000 jobs, but there is a reasonable probability for a later upward revision based on recent experience; and there were an additional 44,000 in upward revisions. The headline unemployment rate fell to 5.1% and several other items such as average hourly earnings, average workweek, and U6 unemployment also improved.) We don't believe there is sufficient volatility in the inflation numbers, for them to make a difference and we don't believe the Fed will be kept on the sidelines by capital market volatility.

As for the Bank of Canada, we expect it will choose not to adjust rates at its upcoming meeting and wait for the Fed's September hike – the C$ should weaken in the process. However, we recognize that the Bank has been inclined, of late, to surprise investors, and therefore place some probability of a September hike despite improvement in the trade data.

US-Canada 10 and 30-year yields spreads are extremely wide and may reach historically wide levels once the Fed begins to raise rates. Nevertheless, we anticipate a rise in longer term Canadian yields and a steepening of the Canadian yield curve, which justifies a shorter portfolio duration with an overweight in the middle of the yield curve. At today's yields, there is not much protection for longer term bonds for any rise in yields.

Corporate spread levels currently represent more than half of all-in-yields and thus provide good relative value. Our preference is for shorter term positions where there is relatively good protection against yield spread widening. The portfolio is structured conservatively, possesses good liquidity, and therefore is well positioned to capitalize on relative value and yield enhancement opportunities.

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