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LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

After rallying hard in January, North American bonds were more circumspect in February, with yields rebounding in both Canada and the US. In Canada, however, yields ended the month still hovering close to the historical lows seen at the beginning of the month – 10-year Government of Canada yields had dropped to 1.12% which is well below the historical US Treasury low of 1.41% seen in July 2012 following the extension of Operation Twist. While US Treasuries were pushed to their lows on the back of aggressive QE, Canada bonds have needed only the catalyst provided by an "*insurance"* rate cut by the Bank of Canada in January and fleeting dovish sentiments.

US Treasury yields rose significantly during February – 2's rose by 17 basis points while 5's and 10's jumped by 35 bps each. January's bond rally was fuelled by QE (announced by the ECB and renewed by the BoJ) despite improving US economic data. In February however, all eyes reverted back to the Fed and Janet Yellen, who presented a consistent message at her "*Semiannual Monetary Policy Report to the Congress"* of policy change sometime later this year. Given the improvement in the US economy, notwithstanding weakness outside the US and a very strong US dollar, investors appear to have begun the arduous task of normalising US bond yields. To put things in perspective, **real** 10-year Treasury yields were 0.16% at month-end, reasonable given current 1.3% Core PCE inflation and 1.99% nominal 10-year Treasury yields, but unreasonable given US GDP growth – somewhere between 2.5% and 3%.

Government of Canada real yields ended the month negative all the way up to 20 years to maturity, which would be rather ominous were it not for the fact that Central Banks globally (including the Bank of Canada) are wreaking havoc within global bond markets and distorting the transparency of market yields and prices. Nevertheless, it is not surprising that inflation expectations have declined, given the dramatic fall of energy prices, but the correspondingly dramatic fall in the Canadian dollar should provide some amount of offsetting inflation. However, Canadian nominal yields are so low mainly because real yields are so low, which seems unreasonable to us given the amount of growth still being delivered by the Canadian economy. It is true that the energy sector is taking a massive hit (the Bank of Canada estimates a 1% hit to GDP), but manufacturing exports have perked up and much of the domestic real estate market is still intact.

Negative nominal yields are now a reality in parts of Europe, such as Germany, Switzerland and Denmark, but in those countries it is the central banks (through ECB QE and negative overnight rates) coupled with deflationary expectations that are driving nominal yields lower. The demand for high quality sovereign assets in Europe is so severe (from mandated investors and currency positions in addition to prospective ECB purchases) that real 10-year Bund yields are now trading at about -1%. In Canada, real 10-year yields are at -0.44%, however not entirely reasonable, considering no Canadian QE program is expected and there is little interest in Canadian dollar positions.

With the advent of European QE program and the backdrop of strong US growth prospects, credit is once again enjoying relatively strong demand. Corporate bonds solidly outperformed Government of Canada's during February with yields spreads narrowing 1, 6 and 6 bps in the short, mid and long areas. The best performing industries were energy, pipelines and utilities – spreads came in 12, 6, 5 bps respectively. No surprise that issuers were keen to take advantage of the positive sentiment with $8.4 billion dollars in new issuance concentrated in financials.

Outlook & Strategy

We have been confident that the US growth would continue its strong recovery, and believe that low energy prices, and low interest rates (whatever the Fed should decide) will only add to this story. Although wage pressures have been largely absent, we are starting to see signs of higher wages in certain pockets (the Walmart hike to minimum wages, while not that surprising given minimum wage increases across many states, was noteworthy none-the-less). We expect the Fed to raise interest rates beginning as early as Q2, and to proceed in a gradual, cautious manner. The US yield curve will likely flatten further, but longer term yields will rise nonetheless. In contrast, the Canadian yield curve will steepen further, as the front-end continues to be priced for easy monetary policy and the back-end follows the US back-end. (This week's Bank of Canada non-move and dovish remarks illustrate just how delicately balanced is the Canadian yield curve.) The current portfolio structure is optimally positioned for this "*bear steepening*" of the yield curve, with a concentration in 5-years and an overall short duration. We are comfortable with our overweight in short credit, recognising this sector has the best risk/return characteristics in the bond market. The risk to our forecast and hence the portfolio is that long yields fall, rather than rise, should the US economy weaken or US deflation fears predominate.

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