LORICA | INVESTMENT COUNSEL INC.

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Focused Fixed Income

Market Highlights

The start to the year for the Canadian bond market can only be described as extraordinary: the Bank of Canada lowered interest rates, surprising everyone and taking the dollar down another 4.3 cents; Canadian real yields dropped further into negative territory all the way up to 15-years; and nominal long term yields fell below 2%. Global bond markets were no less amazing: the ECB finally announced its formal QE program to begin in March; 11 central banks (besides the Bank of Canada) lowered interest rates with nominal yields falling negative for some of the highest rated European sovereigns and even some related premium grade corporate credits.

The Canadian Universe index returned 4.63% for January, the highest monthly return since February 1995 (when the Universe yield to maturity fell about 90 bps to 8.40%), consistent with the fall in yields, but juiced by the lengthened duration of the index – now at 7.6 years. Long bonds were the clear winner during the month, with 30-year government of Canada's returning 12.8%, despite the low average monthly yield to maturity of 2.11% – outside of program specific long bond activity (e.g. insurers and pension funds), this part of the market can only be viewed as a playground for speculative capital gains and eventual losses. The Canadian yield curve steepened, pricing in an additional rate cut this year, while the US yield curve flattened, still pricing Fed tightening. Long bond yields in both markets continued to benefit from foreign flows seeking safety and yield pickup, particularly in the Treasury market.

Our take on the bond market is that economic fundamentals are playing a distant second to central bank activity, which is unprecedented. In a world of high debt levels, deflation, and depreciating currencies, central banks have taken over from elected officials as guardians of the economy and are more than willing to undertake aggressive policy action. The Bank of Canada joined the chorus, despite having previously convinced investors they were focused on inflation, yet satisfied to look through short term shocks. However, the significant problem with excessive central bank intervention is the distortion of market behaviour and the impairment of prices as a mechanism to convey information beyond such action. Not surprisingly, bond markets are increasingly traded on expectations of central bank actions which, since the adoption of QE policies, have migrated out the yield curve; valuation has become largely irrelevant.

It is our belief that Canadian nominal yields can only persist below the level of inflation and some term premium if market participants expect inflation to go even lower or if real yields have a reason to remain negative. On both accounts we find it hard to see a rational argument for nominal yields to stay at such low levels. Admittedly, the near term impact of the sharp decline in oil prices has been a fall in overall inflation. However, medium term, lower gas prices, a severely devalued loonie and lower bond yields should ensure that core inflation does not suffer a commensurate decline. As for real yields, absent a recession and additional QE programs, it is improbable that Canadian real yields remain negative beyond short term interest rates.

We note that there are researchers, such as those from the New York Fed, suggesting that term premiums, or the additional yield received for the uncertainty of longer term investments, have declined. Lower term premiums mean investors are not rewarded with the same yield increment for risking longer term investments as they would have in the past. In other words, we may have to get used to flatter yield curves. We suggest that as long as QE and the by-products of QE (i.e. bloated central bank balance sheets and significantly reduced volumes of tradable debt) are in evidence, lower term premiums may in fact be a feature of developed bond markets.

Outlook & Strategy

We are confident that US growth will continue its strong recovery, and believe that low energy prices will only add to this story. Although wage pressures have been largely absent, we anticipate that further employment gains will translate to higher wages. 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. 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. The risk to our forecast, and hence the portfolio, is that US long yields fall, rather than rise, should the US economy weaken or US deflation fears predominate. At this point, we do not see much risk of North American yields being dragged lower on the back of further European yield declines.

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