LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

All eyes were on the Fed in the third quarter but it surprised, if not disappointed, many by holding interest rates steady. It should be noted that investors were largely not willing to position for a move until one actually took place – Fed Fund futures had a 28% probability of a rise vs. economists at 49%. The mantra of "data dependency" has been central to the FOMC's decision not to raise rates, although what that data is, is certainly up for conjecture. The domestic economic data had generally improved during the quarter and was, at a minimum, suggestive that ZIRP is no longer necessary. However, global data, particularly as it relates to China and emerging markets, had been far more troubling. Add to this, the pressure exerted on the Fed to stay pat by the IMF and the World Bank, amongst others, and one realises that "data dependency" is a much nuanced term. In any event, getting off zero was always going to be more difficult than getting there (when overshooting by the bond market was actually desirable).

The Bank of Canada was noticeably quiet in the second half of the quarter, after stealing the spotlight from the Fed (who generally draws more attention despite being a foreign entity) with a trail of potent comments and July's rate decrease. Although first half GDP data, released in Q3, imply a H1 recession based solely on GDP, other data suggest more resilience in the domestic economy, particularly in services, and some improvement in non-commodity exports. For now, the Bank appears content to let its earlier actions play out.

Market volatility has been a casualty of the uncertainty surrounding the Fed, and this was in evidence in all asset classes in Q3, particularly September. The VIX (Chicago Board Options Exchange Volatility Index) was off the charts, posting the highest numbers in September since the European debt crisis in 2011. Bond yields were also volatile, particularly for high yield bonds, where spreads have widened in tandem with increased equity volatility and are now at the widest levels since 2012 (BofA Merrill Lynch US High Yield Master II Option-Adjusted Yield Spreads). Canadian Investment grade spreads were also volatile, widening during the quarter along the entire yield curve, decreasing marginally with an increase in term.

Although corporates underperformed governments (for similar terms) for both September and the quarter, this was particularly true for mid and long terms, where the protection offered by the yield spreads is insufficient to offset the much higher durations. Year-to-date, in the corporate sector, only short term bonds have offered a return advantage over similar term Government of Canada's. This was also true of short provincials.

Portfolio Activity

Corporate supply pressures and a steepening provincial credit curve presented the opportunity to increase exposure to these sectors at attractive levels. Overall credit quality was improved while the portfolio's duration and yield curve bias for rising rates and a steepening yield curve was maintained.

What Worked In The Quarter

The portfolio was significantly underweight provincial credit on a duration weighted basis as short, mid and long-term provincial spreads widened by 7, 21 and 23 basis points respectively. The portfolios provincial holdings are concentrated in short and mid-term Ontario and Quebec issues which were top performers in the sector. The portfolio's credit quality (which increases with term) was positive, as spread widening from AA to BBB-rated debt increased as one moved out the credit curve.

What Didn't Work In The Quarter

Relative to the index, the portfolio is more conservatively structured with a shorter-duration and an overweight in the 5 year area of the yield curve in lieu of long bonds. For the quarter, underlying 2 year government yields rose by 4 basis points whereas 5, 10 and 30 year government yields fell by 14, 24 and 9 basis points respectively.

Outlook & Strategy

Central Banks have become the nemesis of many investors, and unfortunately we find ourselves in that category. The adage goes "don't fight the Fed", and we have generally subscribed to this belief, although now, we are less certain of *who we are or are not fighting and what we are (not) fighting about*. Nonetheless, we think the Fed may have closed the window for raising Fed Funds this year. That being said, there is still little advantage to owning more duration in the Canadian bond market, given the low level of yields, the relatively flat yield curve (Canada's 30-overnight is 170 bps vs. 270 bps for similar US Treasuries), the high price value of a basis point, and the unlikelihood of sustainable capital gains. Furthermore, more monetary policy relief by the Bank of Canada, though unlikely given the already depreciated Loonie; would likely have relatively little impact on longer term yields.

We still believe that investment grade corporate bonds with shorter maturities offer the best value and risk/reward relationship in the Canadian bond market. Broadly speaking, we are not concerned about the fundamentals, noting that most industries with significant bond issuance have decent credit metrics. However, on a short term basis, lack of market liquidity will still create challenges for corporate bond investment.

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