LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The main themes in the Canadian bond market during April were the outperformance of credit – particularly corporates, the backup in Canadian yields and the dramatic flattening of the 30-10 year part of the Government of Canada yield curve. Policy actions precipitated some of the market moves:
i. downward revisions to the Fed's March projections for the Federal Funds rate together with Janet Yellen's end of month speech gave a greenlight for "risk-on" trades which translated into narrow corporate spreads; and ii. as part of the Minister of Finance's 2016 Budget, the government released its Debt Management Strategy for 2016-17 which indicated additional government issuance of about $40 Billion with a focus on 2, 3 and 5-year maturities (with the possibility of 50-year bonds), creating demand for longer term issues. The rise in Canadian yields was largely in response to the surprisingly positive Canadian economic data released during April.

Corporate yield spreads narrowed across the credit spectrum, with the best performance coming from the most risky credits. Using the FTSE TMX Mid Term Bond Index for indicative purposes, BBB Mid Term Corporate yield spreads narrowed by 21 bps over the month, followed by 15 bps for A's and 12 bps for AA's. Spread performance was consistent across terms with short, mid, and long spreads narrowing by 14, 18, and 16 bps respectively. In terms of April's total return outperformance versus Canadas, longs outperformed by 2.57%, followed by mids at 1.53% and shorts at 0.51%. However, on a risk-adjusted basis (outperformance per duration), mids were the top performers, followed by shorts and then longs. Short corporates do well on a risk adjusted basis due to their superior break-even (wide spreads, low duration) and roll-down (relatively steep short yield curve) characteristics.

The Canadian yield curve continued its flattening ways in April, with the 30-2 year Canada yield spread narrowing by 7 bps, bringing the total for the year to 27 bps. Interestingly, the 10-2 year curve steepened in April by 13 bps after having flattened by 22 bps in the first quarter. So far this year, most of the flattening of the yield curve has come from the long end: in April the 10-30 Canada curve flattened by a whopping 20 bps. In contrast, the 30-10 US Treasury was almost unchanged in April and steepened by about 9 bps in Q1.

April's backup of Canadian yields did not follow a US lead, but was rather a made-in-Canada story. In Q1, Canada yields fell in response to weak economic data and even weaker expectations. However, January's GDP surprise of 0.6% mom and a very solid payroll report for March (+41,000) were catalysts to drive yields back up. It still remains to be seen if investors have over-reacted, especially given the significant reversal of the Canadian dollar.

Outlook & Strategy

We expect the Fed and investors to continue their game of "Fed Funds hike hide and seek" this year, which is unlikely to produce more than two "discoveries" (hikes). Volatility will still be very evident. Importantly, we do not see the Fed as willing to completely eradicate the "risk on" trade, which includes some underlying bid for corporates. We expect the Bank of Canada to remain safely on the sidelines: on one hand it is facing considerable economic headwinds, while on the other recent economic data has been surprisingly positive and there is considerable fiscal stimulus in the pipeline.

We will continue with our strategic short bias, but will also look for opportunities to take advantage of yield and yield curve volatility. In addition, the corporate portion of the portfolio contains good liquidity which enables us to capitalize on relative value and yield enhancement opportunities that may arise in the sector.

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