February 29, 2016

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

North American bond yields were extremely volatile during February, as investors flirted with the notion of a weakening globally economy and the potential for a US recession. 10-year US Treasury yields fell by as much 26 basis points, from already depressed levels, only to rebound by 8 bps at month-end and another 9 bps as of time of writing. Canadian government yields were just as volatile, with 10-year yields dropping by 23 bps during the month, and rebounding by 19 at month end, and another 8 bps as of time of writing. To put the volatility of the bond market in perspective, the Universe Canada index [1]returned 0.29% for the month, but was up 1.43% at the trough in yields, only to give back 1.13% over the remainder of the month.

The Canadian government yield curve flattened during the month by 11 basis points between 1 and 30-years. Short term interest rates rose slightly as the prospects for further monetary policy from the Bank of Canada (rate hikes or unconventional measures) diminished as the prospects for substantial government spending gained momentum. Longer term yields were dragged lower by the declining yield structure globally – notably in Europe and Japan, as investors responded to the weak economic fundamentals and declining inflation expectations.

The corporate bond market was under pressure causing yield spreads to widen, particularly for lower rated issues. Looking at the Mid Term Bond Index (to eliminate duration differences) Canada's returned 0.18% for the month, compared to 0.19% for provincials and -0.25% for corporates. Notably mid-term A's and BBB's returned -0.37% and -0.30% respectively: the poorer performance coming largely from A and BBB-rated energy issues comprising nearly ¼ of the Mid Term corporate weight, which returned -0.71%; and to a lesser degree Financials comprising 28% of the index, which returned -0.15%. The pattern of underperformance was similar for short and long corporates. However, the flattening of the yield curve benefitted long corporate bonds, resulting in positive overall returns.

After the outright negative sentiment towards the economy in January, feelings were more nuanced in February. Investors continued to act as though the only thing that matters is energy, with stock and bond markets oscillating with oil prices, but the news on energy was not as unilaterally negative. Capacity continued to decline and there were more concrete discussions of supply constraint by major producers. Global economic data did not show much progress, but the US data was strong enough to discredit recession expectations. While the Canadian economy continues to be under immense strain, hereto, the data was better than expected.

Outlook & Strategy

Markets are no longer fully pricing a Fed rate hike in 2016, with the probability of a hike by December at only 65%. We are optimistic on outlook for the US economy, but recognize there are substantial problems elsewhere. Nevertheless, we still expect the Fed to raise rates this year, but that weaker global markets will deter it from abiding to, what we had previously expected to be, a more rapid schedule – two increases will probably be the limit. That being said, the Canadian yield curve offers very little protection, particularly for longer-dated issues, and therefore do not believe it is appropriate to hold longer maturities. Our portfolios will maintain a concentration in shorter-term issues.

The corporate bond market has certainly come under pressure lately, with yield spreads widening past short-term break-evens. Only in the long-end have corporate returns remained positive, year-to-date. However, we still believe that break-evens are most attractive for short corporates, and will generate in positive returns over the course of the year. Our portfolios will maintain an overweight in higher quality shorter-term corporates.

[1] FTSE TMX Canada Universe Canada (Non-Agency) Bond Index

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