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LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

It should come as no surprise that the unpredictable election result was also a shock to bond investors and thus continued the unexpected repricing action that has gripped the bond market since the beginning of Q4. In our last commentary we suggested that the bond market was suffering from central bank exhaustion, having become so reliant on global central banks to unfurl supportive policies that have lowered and flattened sovereign yield curves globally. We believe that the ECB and the BoJ had hit a proverbial wall, with the Fed having already retreated some time ago, causing yields to back up during October. Perhaps, in hindsight, some of the move during the month, was the pricing in of some probability of a Trump victory, although, we would suggest this would have been limited.

Following the election, we believe bond investors have priced in more symmetry of risk in the bond market. Prior to Q4, we felt that yield risk was mostly on the downside as both the ECB and BoJ seemed intent on continuing aggressive asset purchases, while credibility of Fed rate increases continued to be lacking. As for the Bank of Canada, we think it is on the sidelines, despite having indicated consideration of further stimulus in its recent Monetary Policy Report, while waiting for market uncertainty to dissipate. (We think that there is still a likelihood of downward pressure on the $CAD, so long as Canadian and US monetary policies diverge and there is no significant reversal to energy prices.)

There are some commentators who maintain that the market is pricing in a best case scenario to President-elect Trump's economic policies – fiscal (tax cuts and infrastructure spending), regulatory (Dodd-Frank and, pipelines) and trade (China, NAFTA, etc.). We believe that if the best case unfolds, we will see even higher yields; but for now the market is putting a wedge between itself and policy status quo (including monetary policy).

More recent economic data has also given more credence to the idea of a Fed rate increase before the end of the year which, for its part, the Fed has tried to telegraph. Fed credibility is still an issue, but the Fed seems to be more self-aware than ever, and we find it hard to envision another false signal without a very significant market event. From the November 1-2 FOMC meeting minutes: "Some participants noted that recent Committee communications were consistent with an increase in the target range for the federal funds rate in the near term or argued that to preserve credibility, such an increase should occur at the next meeting."

We note the recent improvement in US data. Industrial data, including the manufacturing PMI, and the Empire and a majority of the district manufacturing indices, were up month-over-month for October. Consumer data was also improved with retail, auto and existing home sales all up. Unfortunately, while employment gains continue to be healthy, income remains a sore point with average hourly earnings bumpy: –0.1% MoM in November, albeit averaging 2.5% YoY so far this year.

Canadian data was mixed, with manufacturing up slightly, although down by volume; housing starts down, although prices were up driven by Toronto, with Vancouver more muted; and employment up, although troubling given the outsized gains in part-time employment.

Outlook & Strategy

The bond market finally found resistance and risk in October and November respectively. We still believe the path for the Fed is for higher rates, and will see some action, albeit restrained, in the months ahead. Ultimately, we expect a higher trajectory given the likelihood of supportive fiscal policy in the years ahead; though it is difficult to predict time, scale and ultimate effectiveness. The yield curve has steepened from an artificially flattened position, and further optimism around growth would steepen it further. However, we would expect at this juncture to see more volatility to mid and longer term yields as investors try to grapple with the different policy scenarios ahead. Any steepening and flattening in the US will be exaggerated in Canada, given the immovability of the front end of the Canadian yield curve.

We are still positioned more defensively for a steepening yield curve. We still favour an overweight in short term corporate bonds, where the yield spreads and break-evens are attractive on a historical and relative basis. However, we will continue to employ trading strategies to take advantage of relative value and yield enhancement opportunities.

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