October 31, 2016

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

After nine consecutive months of basically positive returns (April was down a marginal −0.08%), the FTSE TMX Universe Bond Index delivered the first month this year of significant negative performance in October, returning −0.91%. The long-end was the worst performer along the yield curve, returning −2.31% for the month, followed by the mid and short-ends at −0.70% and 0.03% respectively. In terms of sectors, on a risk-adjusted basis, corporates had the best performance, followed by provincials, and then Canadas (i.e. according to the Mid Term Bond Index, Corporate, Provincial, and Canada returns were −0.23%, −0.79% and −1.03% respectively). Overall, the best performance was in short corporates (0.17%) where the larger break-evens offered protection against rising yields.

A combination of better data, hawkish signals from the Fed, and US election jitters were the catalysts for the rise in North American yields. US yields rose slightly more than Canadian yields – 10-year Treasury yields rose 23 bps versus 20 bps for Canada's. The Bank of Canada lowered its growth expectations in October's MPR and thereby increased market odds for lower rates. Both US and Canadian yield curves steepened during the month with the US yield curve going from 155 bps to 171 bps (2-30's) versus 115 bps to 130 bps in Canada. Both yield curves are shallow by historical standards for this stage in the economic growth cycle, but explicable given the monetary policy experience of the last few years.

Although US data was generally mixed, employment data continued to be positive, with signs of wage pressures increasing – October's average hourly earnings were up 0.4% MoM. Inflation data was OK, with Core CPI up up 0.2% MoM for September and 2.2% YoY. Other data were less one-sided: manufacturing PMI was strong while some of the regionals were weak; retail and auto sales were strong, but basically a rebound from the very weak prior month; and home sales slipped while prices were higher. Canadian data was also mixed: housing was strong in the core markets, although this could be misleading with regulatory effects likely still to come; manufacturing was weak; and most importantly employment was concerning with overall job gains masking the migration from full time employment to less beneficial part-time.

Elsewhere, bond yields were also on the rise, with European and Japanese yields both following the lead of Treasuries during the month. German 10-year yields were up almost 30 bps, going back into positive territory, while 10-year JGB's were up 4 bps. While concern over the US election and the uncertainty relating to the prospect of either candidate winning has sent investors fleeing the traditional safety of the US Treasury market, it would appear that capital is not being directed towards the negligibly yielding markets of Europe.

In addition to offering the best break-even characteristics, the corporate market also experienced yield spread tightening during October. Short, mid, and long-term corporate spreads tightened by 6, 8 and 3 bps respectively during the month, as investors continued to search for yield, particularly in lower-rated short term issues, despite deteriorating corporate fundamentals and reduced new issuance.

Outlook & Strategy

The bond market experienced its first real back-up this year during October, after finding obvious resistance in September. We still believe the path for the Fed is for higher rates, and should see some action, albeit restrained, in the months ahead, notwithstanding unpredictability relating to the US election results. The case for a relatively shallow trajectory for Fed Funds has already been communicated and markets have adjusted with flatter yield curves, leaving little room for further flattening. The Fed is communicating a desire for tightening, but we have seen this before, and "the proof is in the pudding" which, until now, hasn't tasted great. We expect the Bank of Canada to remain on hold despite communication surrounding the MPR that it is more receptive to easier policy – we think a Fed hike will eliminate the need for direct action.

We are positioned more defensively for a steepening yield curve, but will take advantage of excessive steepening. 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 look for trading opportunities to take advantage of market opportunities.

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