LORICA | INVESTMENT COUNSEL INC.

# Focused Fixed Income

## Market Highlights

The tug of war in the bond market continues as investors are confronted with information – both news and data – that is unconvincing either way. Both 10-year US Treasury and Government of Canada yields traded in about 20 basis points ranges during April with 10-year Treasury yields, now 2.35%, back where they were at the end of the first quarter, and 10-year Canada yields about 10 bps below their quarter-end levels. The widening gap between Treasury and Canada yields reflects the divergent monetary policies between the Fed and the Bank of Canada and the growing risks to Canada from incipient US government policies.

On the news front, the US government has regained the attention of investors, most recently with the passing of the Health Care Bill, after having been temporarily displaced by the Fed and its battalion of speakers. We had pointed out in our last month's write-up that it was too early to write off Trump and the Republicans as abject failures, and that the market would still need to price in some probability of policy successes. Although the Health Care Bill has still a long way to go before one can call it a success (at a minimum, it must still get through the Senate), its passage through the House has reminded investors that last year's late surge in yields was not entirely unwarranted. Passage of the Bill increases the possibility of other Trump policies that have the potential for positive economic impact.

On the data front, it was always going to be the case that underlying US economic data would eventually have to support the lofty level of the first quarter's forward looking surveys such as Consumer Confidence and Purchasing Managers. Not surprisingly, actual data released in April, was not nearly as positive as the preceding surveys, giving markets another reason beyond politics to pause; and causing surveys themselves to take a step backwards. The biggest disappointment was the March US employment report which was well below expectations (non-payrolls of 79k versus 180k expected, much lower than the prior 6-month average of 190k; and 2.6% yoy for average hourly earnings) and immediately put into question the idea of wage pressure. Notably, April's employment report saw a bounce back (211k but with a 19k downward revision to March), but with another fall in average hourly earnings (to just 2.5% yoy).

US politics was not just front and centre to US investors; just ask the Bank of Canada and Canadian dollar speculators. The Trump government chose to make Canada, more specifically Canadian dairy producers and lumber mills, the latest whipping boy in its ongoing assault on US trade partners. NAFTA headlines, the Home Capital debacle (coupled with existing concerns over the Toronto housing market) and the normal ebb from the flow of the previous quarter's strong Canadian data prompted a 2.5% decline of the Canadian dollar against the US dollar during the month. In its Monetary Policy Report, the Bank of Canada once again emphasized the uncertainty emanating from the US and the difficulty with outlining a policy strategy – Bank-speak for remaining on hold and stabilising the front end of the Canadian yield curve. Further out the yield curve, Canadian yields lagged end-of-month move upwards in US yields.

## Outlook & Strategy

Our expectations for the Canadian bond market are still for a steeper yield curve, with relatively stable short-term yields and higher long-term yields. Yields in the front-end of the yield curve will not move significantly, consistent with no policy moves from the Bank of Canada who will continue to site enough uncertainty to stay on hold – US trade and taxation policy changes are amongst the most important. We suspect the Bank will remain comfortable with Loonie depreciation against the Dollar as the Fed raises rates and US politicians threaten Canadian trade. Yields in the long-end will move higher with US yields, albeit with a lag, despite a Treasury curve that has been flattening. Although equity markets may be pricing in too much fiscal policy success – translating into some bond market weakness, we do not feel that overall, bond markets have been too optimistic. The recent period has seen the market consolidate around a range, and a move to higher yields will be dependent upon the inflation, labour markets and the Fed. We are taking the Fed more seriously with respect to interest rate hikes – noting the broad communication of the possibility of 3-4 hikes for the year.

We feel there is an increased risk for corporate spreads to come under pressure in the near term, given the potential for the supportive supply/demand imbalance to reverse and the prospect of higher interest rates. However, corporate spread levels currently represent half of all-in-yields and thus provide good relative value and protection. The portfolio possesses good liquidity and is structured conservatively with minimal exposure to sectors or issuers that would be most negatively impacted in the event of higher interest rates.

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