LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The Canadian economy continues to thrive despite all the uncertainty – political, geo-political, trade or weather – coming out of its chief trading partner. Canadian GDP as of June, which admittedly is somewhat rear-view, was running at a lofty 4.3% YoY as reported on August 31st. This is fully 2% ahead of US GDP over the same period. Canada has proven, it is not in fact a one – commodity led – pony, with domestic consumption contributing 79% to growth over the last 12 months. Admittedly, there are areas of concern: consumer indebtedness, lofty housing prices and exports, considering a rising Loonie. However, employment growth has been steady suggesting impending wage growth and underlying support to consumer spending.

While the Canadian economy has easily surpassed expectations this year, the opposite must be said about the US economy. Optimism that followed Trump's election has dissipated almost entirely, if the Treasury market is to be used as a gauge – 10-year Treasury yields which had risen by 85 bps following Trump's victory have subsequently fallen by 51 bps from their peak. Post-election we had postulated that that investors were pricing in some probability of policy success that would be positive for economic growth. However, most of the news coming out of the White House has been disappointing, with legislative failure on healthcare reform, unsettling saber rattling over NAFTA and excessive staff upheaval.

The Canadian yield curve tells the story of the conflicting forces that are impacting the Canadian bond market. In the front end, yields reflect tighter monetary policy from the Bank of Canada, which has responded to the strength of the domestic economy, having rightly concluded that near-zero policy rates are no longer necessary. Further out the yield curve, while US-Canada yield spreads have narrowed – decreasing with longer maturities, longer Canadian yields are partially tracking yields in the US and other developed bond markets, where growth is disappointing and inflation expectations benign.

For most of the last ten years, the Canadian yield curve has been flatter than that of the US (by about 100 bps looking at the 2-30's yield curves), which made sense given the particularly aggressive easy monetary policy from the Fed. For a period, following the BoC's "insurance easing's", the gap closed to about 50 bps reflecting more policy symmetry between the US and Canadian central banks. The gap closed further as both countries indicated tighter monetary policy on the horizon, but has widened since, as the Canadian economy has outperformed and the Bank of Canada has responded, tightening quickly. Longer term, we think it is more likely that US and Canadian economic performances move closer together causing monetary policies, and ultimately yield curves (slopes) to converge.

Outlook & Strategy

In a move that was only partially anticipated by the market (investors had priced-in a 57.4% probability of a 25 bps increase), the Bank of Canada raised rates at its meeting in the first week of September. Last month, we had expected the Bank to move once or twice more this calendar year – August's strong GDP report made one increase a "no-brainer". We still expect another increase this year, despite the rise of the Canadian dollar – it has appreciated 13 cents this year, having risen 6 cents since the last rate hike.

Over the medium-term, further rise in longer-term US and Canadian yields will be dependent upon rising wages and inflation expectations, and central bank actions. We expect the Fed to be active with a combination of balance sheet reduction and one more rate hike. Investors appear to now, be pricing in very little probability of a Trump growth dividend – admittedly, it is difficult to see this sentiment shifting any-time soon. We are positioned for higher yields and a steeper curve – which is still appropriate.

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 about forty percent of all-in-yields and thus, still provide good relative value and protection against rising yields. Overall, 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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