LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

North American bond yields continued trading within ranges established from the beginning of the year. In the front-end of the yield curve, US yields have moved within about a 12 basis point range (2-year Treasuries have ranged between 1.14% and 1.26%) as investors have vacillated back-and-forth regarding expectations of the Fed raising interest rates in March. In Canada, the front-end has been only slightly more stable despite an "on-hold" message from the Bank of Canada (2-year Canada's have ranged between 0.72% and 0.81%). At the longer end of the yield curve, yields have traded within about a 20 basis point range in both countries in concert with changing monetary and fiscal policy expectations. As of time writing (just after month end) longer-term yields have moved close to the middle of the year's trading ranges.

Although the Fed has taken a back seat to the White House since the election, Yellen and crew have worked hard regain some of the attention with a busy calendar of speeches and a generally on-message committee espousing a very definite tilt towards a March rate hike. Although the Fed has disappointed markets during much of Yellen's tenure with false hawkish signals, we find it difficult to imagine a scenario where the FOMC would be so vocal, so in-sync after having faced so much criticism, to once again disappoint. Most importantly, recent data has been supportive of a tighter policy stance with most series turning in positive prints. Though data has been favourable in the past, with no subsequent move, there seems less concern of event risk to cause the Fed to re-think their intentions, this go-round. Although Yellen had highlighted the uncertain political and fiscal environments at the last meeting, she seems to have decided that whatever uncertainty still exists (we suggest not much has materially changed) is not enough to forestall a move from the Fed. Furthermore, there seems to have been a bit of a capitulation on the under-employment theme that has often been used as an excuse for not raising rates – no mention was made in her March 3 speech.

There seems to have been a sea-change in US economic confidence reflected by the surge in equity markets and consumer confidence indices. While many pundits are now warning of excessive valuations – PE multiples are now at 21.8 times for the S&P 500 and 19.3 times (trailing 12 months) for the Dow Jones Industrial versus 18.5 and 15.6 a year ago, respectively (Bloomberg – March 7, 2017). In terms of consumer confidence, the Conference Board index reached its highest level since June 2001 of 114.8, while the University of Michigan Consumer Sentiment Index reached its highest level since January 2004 of 98.5 in January. While the surge in optimism may not be entirely warranted, there has been a corresponding improvement in economic data, notably in the ISM (both manufacturing and non-manufacturing) and similar numbers.

Although the Bank of Canada has been reluctant to deviate from its dovish bias (we assume they still have a preference for a weak Canadian dollar), recent Canadian economic data has surprised to the upside. Employment data, albeit notoriously volatile, has been strong, although with too much of the gains coming from part-time jobs. Housing has continued to contribute, despite the significant drop-off in Vancouver, and the excessive valuations in Toronto. Notably, manufacturing is still disappointing, prompting the Bank of Canada to go from surprise to despair over this sector, and subsequently forcing them to redo their economic models.

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 move from the Bank of Canada, who will continue to site enough uncertainty to warrant staying on hold, while remaining content to watch the Loonie depreciate against the Dollar as the Fed raises rates. Yields in the long-end will move higher with US yields, despite a Treasury curve that we expect to flatten. Although equity markets may be pricing in too much fiscal policy success given current information, we do not feel that overall, bond markets are too optimistic. The recent period has seen the market consolidate around a range, and a move to higher yields will be dependent upon inflation, labour markets and the Fed. We are finally ready to take the Fed more seriously with respect to interest rate hikes – noting that three for the year is a real possibility.

We feel there is an increased risk for corporate spreads to come under pressure in the near term, given the prospect of higher interest rates and the potential for the supportive supply/demand imbalance to reverse. However, corporate spread levels currently represent almost 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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