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LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The long lead-up to the US election was so event-filled one could not be faulted for thinking that the actual presidency would be anticlimactic. However, president Trump's first weeks in the White House have been far from uneventful and have been full of actions and orders. However, there is still so much uncertainty and it will ultimately be the details that matter. For the time being, capital markets seem to be leaning towards policy outcomes that will be supportive for the economy. While equity markets have slowed their ascent, there does not appear to be too much nervousness on the part of investors that Trump policies will be detrimental. The bond market appears to be waiting for more information with yields only slightly higher than where they were at the beginning of the year, despite significant volatility.

The market returned -0.12% for the month according to the FTSE TMX Universe Index with the relatively poor performance of the long end of the yield curve dominating returns. Short, mid and long index returns were 0.21%, 0.19% and -0.83% respectively over the period. The significant exposure to the long end of the yield curve in the provincial sector was responsible for the very poor performance of provincials: -0.52% versus -0.21% for Canadas and 0.41% for corporates. Note the preference for long term issuance by the provinces has resulted in relatively long durations for the sector and the universe – provincials with a sector weight of 34% have a modified duration of 9.64 years versus federals and corporates with modified durations of 5.90 years and 6.09 years respectively. We have opined on many occasions the difficulty with passively tracking the benchmark duration, particularly given the lengthening effect of provincial bonds on the overall duration. We add that the provincial sector with its long maturities is unique to Canada and should be viewed cautiously.

Recent US economic data suggest both GDP growth and core inflation of around 2% for 2016. The US economy continues to chug along, though there are areas, such as manufacturing and housing that have been disappointing. Employment continues to show decent gains which have been positive for consumer sentiment and spending, but have not resulted in significant wage gains. The Canadian economy has also improved with better employment growth, but still faces challenges from overall low energy prices, poor manufacturing exports and pockets of housing weakness. However, significant uncertainties remain including the impact of changes to US trade and taxation policies, Canadian government infrastructure spending and the full repercussions of regulation of foreign real estate purchases in certain markets.

Corporate yield spreads continued their narrowing trend alongside equity market gains. For the month, Canadian short, mid and long-term corporate spreads narrowed by 8, 8 and 7 bps respectively, generating respective returns of 0.42%, 0.76% and 0.15% according to the FTSE TMX All Corporate Bond Indices. Corporate bonds, particularly short to mid-term higher-beta debt, provided a degree of breakeven protection for rising bond yields; the bull steepening of the credit curve reflected investor preference for short and mid-term corporate exposure.

Finally, we note that the Trump administrations intent to hasten approval of the Keystone XL pipeline (one of the administrations first executive orders) caused an immediate boost to the Canadian dollar. However, direct impact on TransCanada credit was muted as too many questions remain unanswered relating to federal and state regulatory approvals, legal challenges from special interest groups, evolving capital costs, and most importantly, terms of the Keystone XL proposal the Trump administration will renegotiate.

Outlook & Strategy

We believe the path for the Fed is towards higher rates, and will see more action, albeit restrained, in 2017. We also 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 a central-bank induced flattened position, and further optimism around growth should steepen it further. We expect to see more volatility to mid and longer term yields as investors try to grapple with the different scenarios ahead. Any steepening and flattening in the US will be exaggerated in Canada, given the stability of Canadian short term rates.

The US political environment poses so many question marks for the global economy and capital markets that we are loathe to make too many predictions. Our bias is that policy changes will be generally supportive of higher growth and inflation. There are also many questions to be answered that are unique to Canada, as a neighbour to the US and its largest trading partner.

We are positioned defensively for a steepening yield curve. We favour an overweight in short term corporates, where the yield spreads and break-evens are attractive on a historical and relative basis. We will continue to look for trading opportunities to take advantage of market movement.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com