July 31, 2017

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The Bank of Canada raised its target for the overnight rate by 25 basis points on July 12, satisfying investors who had priced in as much around 50% probability of a rate increase following strong hints dropped by various Governing Council members in mid-June. At the time of the hike, the market had priced-in 71% probability of an additional hike before year-end; this had been increased to 79% by month-end, despite the appreciation of the Loonie. The Fed was also active, not raising rates, but offering up clear indication that its balance sheet normalization program would begin "relatively soon". Probability of a Fed-hike by year end had dropped to 41.8% by month-end as investors balance normalization with rate hikes.

The reversal of Canadian bond yields that began in June continued into July, although no-longer led by the rise of short-term rates. The 2-10's and 10-30's Canada curves, steepened by 11 and 3 bps respectively (to July 31st) as investors expressed their views that, perhaps, the flattening of the Canada curve was overdone. Despite the move, the 2-30's Canada curve is still about 40 bps flatter on the year (to July 31st) with the 10-30's flattening accounting for about half. Year-to-date, nominal long-term yields are 15 bps higher while real long-term yields are 30 bps higher – implied long-term inflation expectations have thus declined, consistent with lower prints for current inflation (despite a relatively weak Canadian dollar for much of the period).

While US economic data has been largely inconclusive, Canadian data has been undeniably strong; and the Bank's repositioning in June has allowed investors to continue to ratify this view with significant narrowing of US-Canada real yield spreads – the 10-year spread has narrowed by almost 50 bps since the beginning of June and sits just above zero today. The latest GDP report for May, released in July, revealed a Canadian economy that is growing steadily, especially for goods (8.8% yoy), but also for services (3.0% yoy). On the goods side, there were outsized gains in mining (26% yoy) – due to an oil sand's upgrader coming online, but also strong gains in manufacturing (5.2%). On the service side, gains were broadly distributed with wholesale and retail trade, transportation and finance and insurance leading the way. However, like the US, while employment growth has been good, wage growth has been disappointing at 1.3% yoy to June.

Outlook & Strategy

The Bank of Canada has made it clear that they will tighten monetary policy despite many lingering uncertainties – they can no longer ignore the better economic data, and have likely reduced the probability of pro-economic Trump policies being enacted (although unlikely to say so). We expect the Bank to move once or twice more this calendar year; while sensitive to the move of the dollar. The Canadian yield curve and currency have responded to the Bank, with some amount of overshoot and subsequent correction, but ultimately we expect more movement upwards following another rate hike.

We expect the back-end of the Canadian yield curve to catch-up with the rise in the front-end, in the near-term – both US and Canadian yield curves are too flat in our view. However, in the medium-term, a 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 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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