LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Canadian bonds had another strong month, despite intra-month volatility that had 10-year Government of Canada yields trading in a 22 bp range but ultimately falling 12 bps. Short-term Canada's were relatively unchanged, with 2-years trading in a 6 bp range and ending the month just 2 bps lower. Monthly returns according to the FTSE Russell Universe Bond Index were 0.17%, 0.85%, 1.89% and 0.78% for short, mid, long, and Universe Canada's respectively.

While mid and long-term yields were falling in both, Canada and the US, short-term yields were comparatively stable, with the stability reflecting the current consensus around expectations for monetary policy in both countries. In the US, investors are convinced that the Fed will again raise rates at their next meeting in June; while in Canada, investors are convinced that the Bank of Canada will remain on hold. Elsewhere on the yield curve, Canada's have largely followed the lead of US Treasuries.

Recent US economic data has been tepid, with recent weakness in housing, ISM and employment data; but overall the numbers still point to decent growth. In this regard, we are inclined to vote with the Fed, who appears willing to look past the recent weakness. As for the bond market, we believe US yields are largely being influenced by the White House and waning investor optimism over the prospects for government policy success. With so much attention on the alleged Russian election interference story, President Trump is having a tough time redirecting focus to his economic agenda. At the same time, the disappointing progress of any policy initiatives has some investors extrapolating the first 100 days and pushing yields lower in the process.

Turning back to Canada… for the most part, short term yields reflect a relatively dovish-leaning central bank, while the rest of the yield curve moves largely with the US market. However, the potential for underlying crosswinds to have a bigger impact on Canadian yields are significant. Economic data has, on the surface, been strong enough to unmoor the Bank from its stimulative posture and halt the growing disparity with Fed policy – but the Bank remains resolutely on hold. We believe the Bank is keenly aware of underlying fundamentals that show a leveraged consumer driven economy with unsatisfactory trade growth that has not had the desired response to the weak Canadian dollar. Furthermore, there are no doubt substantial risks from higher yields or a weak turn in the economy.

Although corporate bonds delivered positive returns during May, it was mostly on the back of declining government bonds, as yield spreads widened – in Canada, by an average of 7 bps (7, 9 and 5 bps for short, mid and longs respectively). The same sentiments (unwinding of the "Trump trade") that drove Treasuries and Canadas lower also impacted corporate yield spreads during the month. Adding impetus to the spread widening was Moody's broad downgrade of Canadian banks, numerous pieces of unfavourable corporate news, and record new corporate issuance (led by Maples and BBB-rated issues).

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. Despite pressure, from some circles, for the Bank of Canada to act (raise rates or at least indicate a tightening bias), we expect no imminent policy move – the bank will continue to cite too much uncertainty. We expect yields in the long-end to move higher with US yields, albeit with a lag, despite a Treasury curve that has been flattening.

We admit to losing some confidence in the markets willingness to price-in probability of a growth dividend from Trump policies. The recent period has seen the market remove most of the post-election growth dividend. A near-term move to higher yields will be dependent upon the Trump White house regaining some credibility and a reduction in the amount of distractions in Washington. Medium-term, the rise will be dependent upon 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 more than 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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