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LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The bond market story of the day is more yield curve flattening – real yields and inflation expectations be damned! The 2-30's slope stood at 80 and 103 bps for Government of Canada's and Treasuries respectively at the end of November, having flattened by 11 and 24 bps respectively during the month. Most of the flattening has come from the adjustment of short-term yields on the back of the Fed's, and to a lesser degree Bank of Canada's, steady climb to rate normalisation. We say, "real yields be damned", because investors do not seem to be too convinced by the second part of the Fed's monetary policy normalisation – namely its balance sheet unwind. US implied 10-year real yields are at 0.96% – at approximately the same level they were at the beginning of 2014, when balance sheet unwind was a distant thought.

Although the Fed has been clear about the process it will follow to unwind its balance sheet, real yields have had only a measured response. No doubt, the active QE programs of both the ECB and BoJ have had depressing effects on global real yields. Note that European real yields are still in negative territory (e.g. implied 10-year German real yields were -0.83% at the end of November) and Japanese real yields are close to zero. Real Treasury yields were well into negative territory in 2012-13, and again close to zero last year, so there has been some adjustment, but still well below pre-QE levels. We feel that with so much intervention by central banks in the long-term bond market, long-term real yields will have a difficult and uneven adjustment to the reversal of QE, similar to the that experienced during its implementation.

The other component contributing to the stability of long-term nominal yields is the seemingly inviolable limit to long-term inflation expectations. Core inflation in the US and Canada have been anchored below 2% for the last five years and market participants appear to have bought into the notion that it will not easily breach this level. Perhaps it is the globalisation of trade or disruption of technology, but wages do not appear to be under significant pressure despite the relatively low level of unemployment in the US, and to a lesser degree, Canada. Average hourly earnings in the US are hovering between 2% and 3% which has not been sufficient to drive inflation expectations higher.

It looks like 2017 GDP growth will average around 3% in Canada, 2¼ % in the US, and around 3½ % for the world (IMF). The strength of Canadian GDP has been a surprise, but has clearly been buoyed by last year's interest rate cuts, which have provided tangible stimulus to the consumer. Unfortunately, the weak Canadian dollar has not translated into broadening of Canadian exports, as we believe the BoC had hoped.

Outlook & Strategy

There is still a lot of uncertainty emanating from Washington from Tax Reform and NAFTA. Tax reform has the potential to provide significant economic stimulus, but like other policies, such as immigration and health care, may be easily stymied by politicians. The NAFTA negotiations have a wide range of possible outcomes that the Bank of Canada and the rest of us will have to deal with going forward. Although it is very difficult to predict which way negotiations will go (the Bank emphasized that in their recent MPR), the uncertainty is likely already impeding growth, as businesses respond by delaying decisions. We are optimistic that we will see only a moderate impact on Canadian trade, especially given the track record of recent Trump policy initiatives.

As the yield curve flattens, the risk/reward trade-off in the bond market would seem to shift further in favour of shorter-term bonds, unless of course, the economy substantially slows in 2018 – not in our forecast. We have been positioned for higher yields and a steeper yield curve for some time and investor complacency with respect to real yields and inflation expectations has made this an underperforming position in the latter part of 2017. We still expect to see higher long-term nominal yields in both the US and Canada as real yields rise due to Fed balance sheet unwind and slower ECB QE; and inflation expectations increase due tightening of labour markets.

We continue to expect investors to be cautious with exposure to higher levered debt out the credit curve, particularly for those issues with limited secondary market depth. However, corporate spread levels, which currently represent about forty percent of all-in yields, still provide excellent relative value. The corporate allocation has good liquidity and is structured conservatively with minimal exposure to sectors or issuers that would be negatively impacted in the event of higher interest rates; and is well positioned to capitalize on relative value and yield enhancement opportunities.

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