LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Last month we talked about the tendency of the US Treasury curve towards flattening, this trend continued in September. The combination of the Fed's consistent tightening message and below-target core inflation have supported this flattening trend. However, the flattening has been accompanied by a considerable amount of volatility as investors grapple with uncertainty surrounding inflation prospects. Central bankers have only heightened the volatility by highlighting their own confusion over the lack of wage pressures despite apparent tightness in the labour markets - both the Fed and the BoC have recently alluded to this.

In Canada, the yield curve has been particularly volatile as investors vacillate according to the mood of the Bank of Canada – recently Governor Poloz has proven to be less forward looking, and more responsive to recent data. In fairness, the reserve currency status of the Canadian dollar has increased its sensitivity to monetary policy and growth prospects and compounded recent tightening actions by the Bank. With the recent headwinds from exports, housing and NAFTA negotiations, the Bank has motioned a move into the Fed's shadow, stifling the recent flattening move in the US from propagating further into Canada.

In the Bank of Canada's recent Monetary Policy Report, released on October 25th, they indicated concern over the Canadian economy. Six days after the release, Statscan released the first negative GDP print (-0.1% for August) since October of last year. Clearly, growth in the first half of the year was stimulated by the Bank's 50 bps drop in overnight rates last year, and it was inevitable that we would see some giveback. However, we expect that a weaker currency and a rebound in the Ontario housing market will see the economy grow in Q4.

A note for those who like technicals… 10-Year US Treasuries peaked around this time of year, 36 years ago (my career has effectively been entirely during a bull-run in long treasuries punctuated by a few short-term bear markets) – over those 36 years, with each short-term pull-back in treasury yields, there has been a subsequent move to lower lows. We are now in danger of seeing the recent peak of just over 2.60% in March, being breached without a lower low. From a technical standpoint, this would signal a break in the long down-trend and a potential move to the next resistance level at 3%. Recently, the rise in treasury yields has met resistance at 2.4%, and this has given comfort to technicians favouring long positions; but the warning signals are there.

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 Trump initiatives, such as immigration and health care, may be easily stymied by politicians. NAFTA has perhaps, a wide range of outcomes that eventually 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. There is certainly the potential for a significant negative event for Canada, but we are hopeful that rational will prevail.

We have been positioned for higher yields and a steeper yield curve for some time, and bond market volatility has made this both a desirable and undesirable position this year. Most recently, weaker Canadian data has outweighed the hesitancy prevailing in the US bond market, to widen US-Canada yield spreads and generate outperformance by Canadian bonds. However, we still expect to see higher longer term yields as tightness in the labour market eventually gains some traction. (Notably, Canada's October employment report released today was strong at 35.3K job gains and 2.4% increase in hourly wages.)

In terms of credit, we foresee investors being 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, provide good relative value. The portfolio possesses 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.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

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