LORICA | INVESTMENT COUNSEL INC.

April 30, 2018

Focused Fixed Income

Market Highlights

The move in Canadian government yields in April was almost an exact mirror image of the move in February-March (February-March/April - 2's: -7/+7, 5's: -16/+15, 10's: -20/+19, 30's: -14/+17 basis points). Mixed messages from economic data, central bankers and politicians have made it difficult for investors to price assets which has heightened market volatility. Corporate yield spreads have also been volatile, widening in March and narrowing in April. However, subsequent narrowing of lesser quality credits was only limited, with the general direction to wider spreads. Notably, the VIX index – a measure of volatility of the S&P 500 – has been sustained at the highest levels since 2015.

Canadian economic data generally surprised to the upside overall, but amidst large areas of concern. Macro-prudential policies targeting the leveraged and inflated consumer real estate sector have had a dampening effect in Vancouver and Toronto, with the extent of the impact yet to be fully understood. Higher energy prices – the result of supply shortages (OPEC cuts & Venezuela) have helped the Canadian economy, albeit muted by the depressed value of Western Canadian Select versus West Texas Intermediate. International trade, a constant area of disappointment, continues to be a problem, especially with NAFTA negotiations overhanging. And finally, inflation has ticked upwards – perhaps not surprising given the weaker dollar, low unemployment and minimum wage increases.

The Bank of Canada, have at least been consistent, in terms of not divulging much to the market, by way of short-term guidance. Investors have been mostly left to try and interpret communication and Poloz's body language which hasn't been obvious. At this time, the market believes we will see two 25 basis point increases from the Bank this year, back-loaded in the second half. While growth and inflation suggest an earlier response from the Bank might be appropriate, there is enough uncertainty, especially from the trade file, to warrant sitting on the sidelines. The Trump White House has demonstrated a talent for creating havoc, but has ultimately been inconsequential on many fronts. However, the president remains unpredictable, and we would not bet on a benign outcome for Canada, to the NAFTA negotiations.

The US yield curve maintained its flattening bias through April, although having been temporarily disrupted by a more aggressive rise of long bond yields. The Canadian curve faced stronger resistance to further flattening, as the Bank was careful not to project tighter policy and higher short-term rates. Treasuries and Canadas 2-30's are now at 63 and 51 bps respectively, both relatively flat from an historical perspective, although not uncommon for economies headed towards recession. Both countries are in tightening mode which has historically been accompanied by flattening yield curves. However, as we have stated in the past we are coming off a period of QE and negative real yields which have distorted term premiums.

Outlook

Poloz and the Bank of Canada continue to be cautious and non-committal, while the Fed appears to be decisive and committed. The spread between Canadian and US policy rates and short-term yields was unchanged during April, and should remain that way in May, but will likely widen in June with an increase from the Fed. There is always the possibility that the Bank will also raise rates by then, but we are not convinced that NAFTA will be settled by then, not to mention to the satisfaction of the Canadian economy. However, in the meantime investors are clearly worried about the long-term impact of trade policy on the Canadian economy, as evidence by decreased correlation of 10-year and long Canada yields with Treasury yields. In the event of a satisfactory "NAFTA" outcome for Canada, we would expect some narrowing of longer-term US-Canada spreads.

Our portfolios have been positioned for higher yields, which has meant that we have had significantly shorter duration versus the benchmarks and many of our peers. It also has meant that the portfolios have been biased towards steeper yield curves. We expect the portfolio to perform well on a relative basis, as we expect yields to rise, with a steepening yield curve.

Our portfolios are at their maximum corporate weights, with as many better quality short-term maturities as possible. We are also overweight provincial credit (where applicable), albeit generally with longer maturities. The credit overweight both compensates for the yield. disadvantage resulting from the portfolios overall shorter duration and provides additional protection against rising yields.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

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