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LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Trade was once again the dominant geopolitical theme last month. The Trump administration continued its assault on its trading “partners” with China and Canada the current targets. The administration devoted much energy during August to its NAFTA-redo which culminated in a strong-arm of its Mexican neighbours (during isolated US-Mexican trade talks) into a bilateral trade agreement, with Canada still to “play nicely” and sign up. The terms of the agreement will likely disadvantage Mexico over time, but importantly for Canada, also infringed on tri-lateral issues including dispute resolution and intellectual property. Trade has cast a shadow over Canadian capital markets for the entire summer, despite surprisingly strong economic data. However, from a bond market perspective, the uncertainty has not resulted in further widening of US-Canada yield spreads – for July and August, US yields (2 to 30-years) rose an average of 3 bps while Canadian yields rose an average of 7 bps (about 2 bps of the 4 bps average spread narrowing quarter-to-date, came in August). Notably US-Canadian spreads widened by an average of 36 bps during the first two quarters of the year.

Yields dropped during August by an average of 8 bps along the curve in the US and 6 bps in Canada. The Bloomberg Barclays US Aggregate Bond Index returned 0.64% over the month while the FTSE Canada Universe Bond Index returned 0.75%. Year-to-date, the respective returns for the US and Canadian indices are -0.96% and 0.62%. The outperformance in Canada reflects the effect that uncertainty relating to NAFTA negotiations have had on the bond market. Although overall business investment has surprised to the upside (amidst favourable energy prices) and labour markets show very little slack, investors are unwilling to extrapolate too much of the good economic growth into the future.

Yield curve flattening in the US and Canada continued in August, challenging investors to force inversion or allow the curves to steepen back up (early September activity has seen some re-steepening). The US curve reflects the assumption of ¼ point rate hikes per quarter, benign inflation and the supply/demand imbalance in the long end. The Canadian curve is somewhat more complicated, as it cannot be assumed that the Bank of Canada will mirror US monetary policy and Canadian bonds are somewhat of a less “safe-haven alternative” than usual. Nevertheless, the Government of Canada 2-30 yield curve is 19 bps, flatter than the US Treasury 2-30 curve at 39 bps. We are finally seeing some rise in European yields, which is gradually putting pressure on longer-dated North American yields; although part of the rise in Europe is the divergence between Bund yields and those of other European sovereigns.

Outlook

The roadmap for the Bank of Canada is a complicated one given the strength of the economy, Fed policy, and most importantly, the trade file. Were trade not an issue, we would say that it would be a pretty good bet that the Bank of Canada would raise rates two more times this year – even with the trade backdrop, the market is pricing in one hike and 81% chance of another by year-end. Unfortunately, the trade situation is a reality and fraught with many risks. We remain generally optimistic that there will be a trilateral deal with Canada, that won’t be devastating for the economy; however, predicting when it will happen is still difficult. In the meantime, we think that the Bank of Canada will pursue a “normal” course (not our original thesis, but since apparent), with somewhat of a policy handicap, i.e. they will discount the data. In that kind of policy framework, we would say it still gives the Bank the green light to raise rates at least once this year. Of course, an unfavourable “trade” outcome, would likely put the Bank on hold, or even in reverse.

While higher policy rates will have an impact on the portfolio, they are not the only factor; the change in mid and long-term yields will possibly have a greater impact. Over the last year, the US and Canadian yield curves have flattened extensively due to higher policy rates from the Fed and BoC, and little change to long-term inflation expectations. We think the greatest risk to returns in the Canadian bond market will be a re-pricing of the long-end.

The large amount of duration in the Canadian bond market exposes investors to a rise in long yields – the FTSE Canada Universe Bond Index currently has a modified duration of 7.5 years. We have positioned our portfolios more defensively relative to the benchmark and many investors, by shortening duration and having no long-end exposure. An 11 bps increase in 30-year Canada yields would wipe out the entire performance of a 30-year Canada for one year. We are confident that longer-term yields will ultimately rise this cycle but acknowledge there are some who see a recession as a more likely scenario; a recession is possible, but not one that we think is possibly imminent. We think the current flattening of the yield curve has more to do with the distortion to developed country yield curves, that has been created by central bank policies.

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