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LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The Fed is on a mission, after having dithered over raising interest rates for quite a few years, unsure as to whether labour markets were indeed tight despite historically low unemployment rates and simmering wage pressures. It is now led by its new Chairman, Jerome Powell, who many assume will be content to take the mantle from Janet Yellen; we are not so sure. If anything, initial communication suggests a more hawkish bias, noting the appearance of the following statement in his first testimony before the senate financial services committee this week: "In gauging the appropriate path for monetary policy over the next few years, the FOMC will continue to strike a balance between avoiding an overheated economy and bringing PCE price inflation to 2% on a sustained basis." We are also awaiting a host of new appointments to the Fed Board of Governors, that will ultimately influence the tone of the FOMC.

Nevertheless, the bond markets appear to be convinced of the Fed's convictions to tighten policy – Fed Fund futures are now pricing in three 25 bps interest rate hikes this year. We are comfortable with this projection given that US economic fundamentals support further rate normalisation. In Canada, recent weak economic data and structural problems imply less tightening – two 25 bps hikes this year are priced in OIS futures. If anything, we are not sure the Bank will be able to meet investor expectations which may have gotten ahead of the Banks messaging.

The challenges facing the Bank of Canada are substantial: faced with tight labour markets; but also dealing with historically high levels of consumer debt, a vulnerable housing sector, and most importantly trade problems relating to the US assault on NAFTA and the like, and increasingly, the difficulty exploiting the tar sands. Unfortunately, the future of Canada-US trade grows ever-more perilous with the growing influence of the trade hawks within the Trump administration. Last year, friendly comments inspired optimism for the NAFTA negotiations; this year, trade disputes and tariffs, are changing the outlook into pessimism.

The slopes of the Canadian and US yield curves were volatile in February, as investors try to navigate the changing environment for long bond yields. Increasing inflation expectations, the recalibration of real yields, and substantial policy changes including monetary, taxation and trade, are collectively challenging investor theses. Thirty-year yields in the US and Canada moved within ranges of 29 and 15 bps during February; while the slope of the US and Canada yield curves (2-30's) moved between 79 to 109 and 12 to 42 bps respectively.

Outlook

The Canada yield curve tends to follow the direction of the Treasury curve, unless monetary policy is moving in opposite directions, in which case only the movement of mid and long-term yields will be somewhat correlated. We expect US and Canadian policy rates to move in the same direction but the spread to widen in the favour of US rates – the Bank of Canada will not meet market expectations. A parallel shift upwards of the Treasury curve, will drag mid and long-term nominal Canadian yields upwards, albeit to a lesser degree – we expect a bear steepening of the Canada yield curve.

Our portfolio has been positioned for higher yields, which has meant that we have had a significantly shorter duration versus the benchmark and many of our peers. It also has meant that the portfolio has been biased towards a steeper yield curve. In 2017, short and mid-term yields rose, but longer yields fell. So far, this year, yields across the curve have risen – 2's: 10 bps, 5's: 18 bps, 10's: 19 bps and 30's: 11 bps. We expect the portfolio to perform well on a relative basis should, as we expect, yields rise, ultimately with a neutral or steepening yield curve.

Our portfolio is at the maximum corporate weight, with as many better quality short-term maturities as possible. We are also overweight provincial credit, albeit generally with longer maturities. The credit overweight both compensates for the yield disadvantage resulting from the portfolio's overall shorter duration and provides additional protection against rising yields.

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