LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The synchronization of global growth was a key factor contributing to a synchronized backup in global bond yields in January. Ten-year Treasuries, Canada's, Bunds and Guilts all rose, by 32, 25, 21 and 32 basis points respectively; even 10-year JGB's were higher by 4 bps (from 0.04%). The FTSE TMX Canada Universe Index returned a dismal -0.8% for the month, with only short-term corporates offering some level of protection, returning an average of -0.07%.

The trend upwards of Treasury yields started last summer in the front-end of the yield curve, as short-term investors became convinced that the Fed meant business in terms of pursuing a more normalized monetary policy. However, it has taken time for the back-end of the Treasury curve to adjust, as longer-term investors have had to be equally convinced that longer-term yields are at risk from inflation, issuance and central banks globally. During January 2-year and 30-year Treasuries rose by 25 and 20 bps respectively, versus a rise of 50 bps and a fall of 10 bps, respectively during the second half of 2017.

The Canadian yield curve (2-30's) flattened by 3 bps during January after having flattened by 46 bps in H2 of last year. It is typical for sovereign yield curves to flatten during tightening cycles, and we would anticipate that this time will be no different. From June of last year to the end of January, the 2-10 Government of Canada yield curve flattened by 21 bps, versus 31 bps for the 10-30 curve. The exaggerated move in the long-end is atypical of historical experience but follows a similar experience in the US. However, there has been a variety of underlying factors driving demand for long bonds, including ECB and BoJ QE, pension long bond buying ahead of US Tax reform, and complacent inflation expectations despite Fed overtures otherwise.

US economic data was generally positive, with the most noteworthy release being January's employment report which indicated that wages had the greatest yearly increase (2.9%) since prior to the Credit Crisis. Industrial data was notably strong, with more mixed results coming from the consumer. Canadian economic data was more mixed, with more forward-looking data giving more reason for concern.

Strong US economic fundamentals also drove a healthy, broad-based bid to the US stock markets during January with the S&P 500 up by 5.73% in USD. Enthusiasm for US equities did not translate to the Canadian stock market, where the S&P TSX was down by 1.39% in CAD over the month, with only the tech sector having decent returns.

Canadian corporate bonds managed to stay clear of domestic concerns and perform in-line with US corporates. Canadian corporate spreads were tighter by about 8 bps across the curve during the month. Spreads narrowed evenly across the yield curve, reflective of the broad-based risk-on sentiment and credit's appeal during tightening cycles. Traditionally, credit is viewed favourably when rates are rising and economic fundamentals are improving, as they provide a greater degree of downside protection through higher yield carry and spread support.

Outlook

The market is now pricing in policy rate increases of 50 bps from both the Fed and Bank of Canada. The Fed's own projections are slightly more aggressive, with the median expectation of an additional 25 bps – 25 bps were wiped from market expectations with the equity market correction. There is a new sheriff in town and we expect him and his posse to be at least as tough as the last sheriff – we see the likelihood of three 25bps tightening's this year. The Bank of Canada's detachment will likely be more cautious, given the risks related to NAFTA and trade, and less favorable economic fundamentals, leaving the possibility the Bank underdelivers market expectations.

The Canadian yield curve is relatively flat, which has shifted the risk/reward trade-off further in favour of shorter-term bonds, unless the economy were to legitimately slow this year – not in our forecast. We expect to see higher long-term nominal yields, as long-term real yields rise due to Fed balance sheet unwind and slower ECB QE; and inflation expectations increase due to ongoing tightening of labour markets and consequent wage increases. We are positioned for higher yields and will also benefit from a steeper curve – a likely scenario should BoC policy lag Fed policy.

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 thirty-five 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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