May 31, 2018

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Bond market volatility persists… The apparently critical 3% barrier for 10-Year US Treasuries – representing a resistance level that had been in place for 4 ½ years – was broken on April 24th (roughly a quarter after the downward trend that had been in place for roughly 33 years was also broken). Treasury yields continued to rise for another couple of weeks, before the sell-off was abruptly halted by several political events. First, it was the on-again-off-again Italian election outcome that was thrown into disarray with the challenge to the coalition government of the 5 Star Movement and League parties, orchestrated by the Italian president, Sergio Mattarella. Next, it was the Trump administration's reinstitution of steel tariffs on its European and NAFTA trading partners. The bond market was particularly well-bid, as investors scrambled out of higher yielding European periphery countries to the safety of the Treasury market.

Treasuries have consolidated, with 10-years trading in a range from about 2.8% to 3.1%. Government of Canada's have also consolidated with 10-year's trading in a range between 2.2% to 2.5%. Interestingly, the retracement of the highs in Canada, following the Italy and tariffs events, has been far more restrained than in the US. It would appear that investors are not entirely convinced that the Bank of Canada will raise rates, nor are they opting for Canada as a proxy to the US for a flight to safety. It should be noted that the lower yield levels in Canada, concerns over trade and investment, and Loonie weakness make Canada a less attractive safe-haven destination.

Canadian economic data has given the Bank of Canada cause for higher policy rates, and the Bank has suggested they are ready to oblige – the Bank's May statement appeared to signal a greater likelihood of an imminent rate increase. However, most market observers and participants have acknowledged that trade could be a stumbling block for both the economy and the Bank, despite having been generally optimistic on the outcome of the NAFTA negotiations. More recently, investors have slightly reduced expectations of rate increases, but the Overnight Indexed Swaps (OIS) market is still pricing in two increases this year. Despite pressure having been reduced on short rates, the Canadian yield curve flattened through May – the result of stubborn long-end yields. In contrast, US yield curve flattening took a breather during the month, after having flattened consistently since the beginning of February.

The global economy continues to show decent growth (expected to be around 3% by the World Bank) despite the longevity of the cycle – 105 months in the US and 99 months in Canada, approaching the longest post-war expansion of the 1990's. The Fed is clearly on a tightening course, both raising rates and reducing its balance sheet, while the ECB and BoJ remain in easy-mode, with QE programs still operative. However, the ECB's body language suggests that it will begin reversing policy sometime this summer or fall, at the latest. The BoJ has not given indications of policy reversal, and the long-suffering Japanese economy would appear too fragile to expect any imminent shift.

Inflation has not yet been a problem, despite tightening labour markets globally. The most recent blip upwards for headline CPI can be attributed to higher energy prices which have been impacted by higher demand and more importantly, OPEC supply measures (voluntary or otherwise – i.e. Venezuela). However, wages have begun to show signs of creeping upwards in the US, and purportedly, in Europe; Canada's labour markets are similarly tighter. Tight labour markets should eventually lead to higher inflation.

Outlook

We expect the Federal Reserve Board to raise interest rates in June, and two more times this year. In contrast to the Fed and market expectations, we think the Bank of Canada will be forced to play it safe and wait for more clarity on Canada-US trade, before raising rates. The widening spread of overnight rates will contribute to a wider and steeper US-Canada spread curve and a weaker Canadian dollar.

While we have consistently qualified our outlook for the Bank of Canada with the outcome to the NAFTA negotiations, we have generally preferred to be optimistic as to the eventual ramifications for Canada. However, realistically, we are already immersed in negative outcomes with tariffs enacted and a US government clearly determined to get favourable outcomes for the US. Although the current actions represent a relatively small impact on near-term growth, the broader uncertainty is already impacting longer-term growth by hurting investment in Canada.

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. However, Canadian long-term yields have been resistant to rising, but we still expect higher inflation expectations to eventually translate into greater term premiums and a steeper yield curve.

Our portfolios are at their maximum corporate weights (by market value), 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 portfolios overall shorter duration and provides additional protection against rising yields.

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