April 30, 2019

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Government bond yields were mostly in a holding pattern during April, perhaps a preview of what's to come this summer. However, investors seem to have gotten over their winter jitters, when many were ready to toss in the towel to recession fears, buying up government debt after having abandoned credit. Corporate bonds led the way during April, rallying by an average of 9 basis points across the curve - having now recouped over half of last year's spread widening thus far this year. Government yields, however, are well off the highs of last years, and have not risen even to January levels, let alone the much higher peaks of Q4, last year.

The US economy has been decidedly mixed, with most data series well below the extreme levels of 6 months ago, but nowhere close to recession signals. Consumer confidence/sentiment has moderated but is still very much in positive territory and consumption has rebounded. Even the housing market is looking better, having benefitted from the decline in mortgage rates. The most troubling segment of the economy continues to be trade related (e.g. investment), which is not surprising given the wide range of trade-inhibiting government actions of the Trump administration.

The Canadian economy gives us more of a concern, with few bright spots. Trade continues to be a problem on many fronts including US and Chinese tariffs, disincentives for export-oriented investment, and limited rebound of energy exports (given the ability of US producers to come onstream quickly). Domestically, the housing market continues to be problematic, with both Toronto and Vancouver feeling the consequence of foreign buyer and mortgage constraints, last year's rise in mortgage rates and high levels of consumer indebtedness. Finally, consumer debt burdens have continued to rise, which combined with higher borrowing costs, have impeded consumer spending.

Consistent with our thesis that central banks have been more concerned with achieving some kind of rate neutrality than fighting inflation, both the Federal Reserve and the Bank of Canada have been quick to duck for cover in light of uncertainty surrounding the current economic environment. Inflation is clearly not a concern, with US and Canadian headline and core being 2.1%, 1.8% (US) and 1.9%, 1.8% (Canada), respectively, and rate neutrality is an ambiguous concept at best. It is therefore not surprising that both banks have hinted at potentially being closer to neutral than perhaps thought before. Investors have paired back their expectations of a cut from the Fed this year – probability is now just below 50% by year-end (Bloomberg), after bouncing around that level since a high of 82% in late-March. Expectations for a cut from the Bank of Canada, this year, despite weaker economic fundamentals, are now below 15% (also Bloomberg), having risen above 60%, very briefly in March.

Corporate bonds were the best performing sector for the month, followed by provincials and then Canadas. Mid corporates just outperformed short corporates (0.52% vs. 0.48%) on an absolute basis but trailed on a risk-adjusted basis with short corporate yields falling by 9 bps vs. 4 bps for mid corporates. Long corporate yields rose by 4 bps, returning −0.20%. While short and mid corporate and provincial yield spread narrowing was enough to offset the rise in underlying Canada yields, this was not true in the long end, where returns were negative across the board. Canada 2 and 5-year yields rose by 1 bp and 10 and 30-year yields by 7 and 9 bps, respectively. (All returns according to FTSE Debt Market Indices.)

Outlook & Strategy

We expect the US economy to deliver reasonable growth with tighter labour markets and higher wages throughout 2019. However, the challenging trade environment and consequent impact on global growth will ensure slower North American growth. Canadian growth will be further impacted by a softer housing market and weak energy prices. We still think it possible that the Federal Reserve will deliver one rate hike later this year, although they have guided for caution and the sidelines; we don't expect the Bank of Canada to do anything. Real yields should eventually expand in the longer-end of the yield curve, resulting in a steeper yield curve. However, falling global sovereign yields and resulting foreign flows into North American bond markets will remain a significant factor, depressing longer-term US and Canadian real yields. Finally, we believe that tight labour markets should eventually push inflation expectations higher, but given recent experience, are hesitant to predict the timing of this move.

In terms of credit markets, growth of both the proportion of long-term credit outstanding and the high-yield debt market have increased the risk of the domestic corporate bond market, making it more sensitive to higher interest rates and global event risks. Conversely, highly rated, liquid, short and mid-term credit are attractive on both an absolute and relative value basis. We continue to maintain a relatively defensive credit positioning in the portfolio, with an overweight in shorter duration, liquid, high quality corporate bonds, and exposure to longer-term provincials. We are well positioned to capitalize on relative value and yield enhancement opportunities.

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