February 28, 2019

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

North American bonds traded in a relatively narrow range throughout February – e.g. the ranges for 2 and 10-year Treasuries and Canada's were about 10 bps (2.47-2.54% and 1.75- 1.84% for respective 2-years and 2.64-2.72% and 1.86-1.96% for respective 10-years). Investors sat on the sidelines, unable to pay too much attention to economic data that may be irrelevant in light of the continuously evolving trade environment, and to central bankers who have largely backed away from their preferred guidance strategies. However, they appear to have become gradually more comfortable with the status quo, i.e. an economy not going into recession and central banks that are not imminently raising rates. The biggest beneficiary in the bond market over the month was corporates, where investors have continued their preference for credit risk, resulting in further narrowing of yield spreads across the yield curve and ratings.

The VIX Index (Chicago Board Options Exchange SPX Volatility Index) – a popular measure of equity market volatility (and uncertainty) settled in February, after a huge decline through January from the extreme levels seen in December. Riskier assets have benefitted from the relative calm with US and Canadian equity market returns for February of 3.21% (S&P 500 Index) and 3.15% (S&P TSX Index) respectively, and high yield bond returns of 1.66% in the US ($US, Bloomberg Barclays US Corporate High Yield Index) and 1.57% in Canada ($CAD, FTSE Russell High Yield Bond Index).

Although markets are steadier as investors seemingly adapt to political and central bank indecision, the economic outlook still remains uncertain, underscored by a significant list of extraneous factors including: the US-China trade conflict, the Mexican Wall, the Mueller investigation, and the Fed. In Canada, we also have a fall election that no longer seems so far away nor benign, and a central Bank that too, is emphasizing data dependency. The economic data has definitely slowed, but not necessarily pointing to recession as some had thought last fall – we feel the Fed can no longer be accused of committing a policy error leading to an inevitable slowdown and recession.

The strength of employment still represents the source of greatest confidence in the US and to a lesser degree, Canadian economies (notwithstanding that historically low unemployment rates are ultimately a constraint on growth due to a developing shortage of skilled workers). However, the slowing of the global economy and widening cracks in the global trade system are clear risks to future growth.

Outlook & Strategy

We still expect the US economy to deliver reasonable growth, tighter labour markets and higher wages over time. We have reduced our expectations of the Federal Reserve to one rate hike later in the year, besting market expectations of no hike, although consistent with the Fed's December dot plots; noting that the Fed has walked back its position with various statements relating to data dependency. We expect the Bank of Canada to follow the Fed's lead, but lag by a hike – implying likely no move – over the same period.

Real yields will eventually expand across the yield curve, resulting in higher yields. Higher wages will eventually result in higher medium to long-term inflation expectations, ultimately putting steepening pressure on the curve. Global sovereign flows remain a wildcard factor, affecting longer term US and Canadian yields.

Growth of both the high-yield debt market and the proportion of long-term debt outstanding, has 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 corporate bonds are attractive on both an absolute and relative value basis.

We do not expect to see much directionality of yield movements in the near term. Accordingly, we have reduced the size of the defensive position in the portfolio, by lengthening the duration. We will continue to look for opportunities to adjust the duration to take advantage of market volatility. We still have an overweight in shorter duration, liquid, high quality corporate bonds and are well positioned to capitalize on relative value and yield enhancement opportunities.

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