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LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

After 68 and 71 bp declines in 10-year Treasuries and Canadas respectively in November to early January, yields bounced slightly by 8 and 5 bps respectively, to the end of the month. However, risk assets recouped some of their losses of last year, led by gains in equities. After the S&P 500 and S&P TSX indices fell by 16% and 10% bps respectively at the end of 2019, they experienced substantial reversals this year with gains of 15% and 13% respectively. The fall and subsequent rise of US equities were the largest in the last 7 and 10 years, respectively.

In the fourth quarter, markets were responding to economic data that had turned weaker, a deteriorating global trade outlook with escalation of the US-China trade conflict, the US government shut-down, lofty valuations, and a decisively hawkish Fed. However, the market decline for risk assets, appears to have gotten way ahead of the data and the Fed. Surprisingly strong employment reports, a temporary reprieve for government workers, and most importantly a partial retreat by the Fed were enough to reverse market sentiment early in the new year.

Parts of the US Treasury curve are once again flirting with inversion as mid-term Treasury yields have fallen, albeit fleetingly, below short-term Treasury yields, while there is still some curve left in the longer part of the yield curve. The decline of mid-term yields was largely due to the fall of inflation expectations. However, the continued decline in January was due to the fall of real yields which was not similarly seen in very short-term yields, which were impacted by repricing of Fed Fund expectations. We note that the probability of Fed Funds increasing by one hike (25 bps) during 2019 declined to below 50% midway through December, as implied by Fed Fund futures, and by the beginning of January, the market was implying an ease by the end of 2019. However, market sentiment reversed during January, with Fed Fund futures now implying no change in overnight rates to the end of the year. The Canadian yield curve is similarly flat, although currently does not display any inversion. According to Bankers Acceptance futures, markets are not pricing in a probability of any increase in Canadian overnight rates during 2019.

Both the Fed and the Bank of Canada have dialed back any kind of forward policy guidance, electing to play the data dependency card. This strategy is a perfect fit for the current environment with so many unknown outcomes dependent upon political events. The apparent halting to further tightening by the Fed has been interpreted as somewhat of a risk-on signal by capital markets. However, some analysts have taken the change of tack as a validation of data dependency, while others have concluded that policy rates are already close to neutral.

Canadian investment grade corporate bonds, despite having fared much better than riskier grades and asset classes when sentiment soured last year, benefitted from the changed sentiment towards risk assets during the month. Domestic corporate spreads tightened by an average of 15 bps across the curve, and issuance, which had taken a hiatus during December, reappeared during January, albeit at below-average pace, for a total of $5.5 Billion in financings.

Outlook & Strategy

We still expect the US economy to deliver reasonable growth, tighter labour markets and higher wages this year. We have reduced our expectations of the Federal Reserve to one rate hike over the next twelve months, besting market expectations of no hike, although consistent with the Fed's December dot plots; noting that the Fed has somewhat 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 should continue to expand across the yield curve, resulting in higher yields. Higher wages will eventually result in higher medium to long-term inflation expectations, ultimately placing some 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 continue to maintain a defensive posture in the portfolio, with shorter duration, no long-end exposure, and an overweight in shorter duration, liquid, high quality corporate bonds. In addition, we are well positioned to capitalize on relative value and yield enhancement opportunities.

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