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LORICA | INVESTMENT COUNSEL INC.

# Focused Fixed Income

**Market Highlights**

In past seasons, this time of year (no not winter), when the press has carried headlines about trade, it would typically be referring to NHL or NBA (GO RAPS) trades. And while pro-sport trades are still top-of-mind, they've been relegated to the sports page with, front-page trade headlines referring primarily to US-China, US-Mexico-Canada, US-Japan and US-Europe trade conflicts. And it seems that no part of every-day life is able to escape the emerging trade problems, especially when many political agendas are seamlessly related to trade. It was only a few weeks ago, when it appeared as though the only barrier to ratification of the USMCA involved bringing Congress on side – no small feat in of itself – only to be kyboshed by a Trump Tweet linking illegal migration originating from Mexico and new tariffs on Mexican exports. Not surprisingly, capital markets, which have been at the mercy of trade actions since the beginning of the Trump presidency have been dominated by the escalation of the US-China trade war (yes war!).

Economic data shows a US economy that is slowing, but in our view, is not yet recessionary. That is not to suggest that it may not turn so, given the imposition of tariffs and counter-tariffs. However, we also think that recent comments coming out of Fed membership suggesting that the Fed is acutely aware of the potential ramifications of trade conflicts and appears ready to respond, must be taken at face value. Data has been mixed, with industrial series (ISM & PMI) trending downwards, while consumer data (retail sales & housing) and sentiment generally remaining strong.

The bond market has responded with a continuation of the rally that started late last year. US yields (10-years) having seen the steepest rally since 2011, with 2-year yields experiencing the largest decline since the credit crisis and 10-years since 2015. All of last year's yield rise across the yield curve has been wiped out – the product of reversed Fed expectations and a flattening yield curve. 2, 5, 10 and 30-year Treasuries fell by 34, 37, 38 and 36 bps in the month and 57, 60, 56, 45 bps year-to-date, respectively.

The Canadian sovereign bond market underperformed the US sovereign bond market significantly in May after tracking it relatively closely in since the beginning of the year. Government of Canada 2, 5, 10 and 30-year yields fell by 13, 17, 22 and 22 bps in the month and 43, 52, 48 and 41 bps year-to-date, respectively. However, Canadian corporates fared far better than their counterparts with investment grade spreads widening by 4 bps versus 18 and 15 bps for US and global investment grade spreads, respectively.

Both the Canadian and US yield curves flattened during May as diminished inflation expectations and term premiums outpaced expectations of easier monetary policy. However, so far in June, the US curve has steepened dramatically in response to intonations by the Fed that easing is definitely on the table. The Canadian curve has steepened in sympathy, but less so, owing to the Bank of Canada's more steadfast position as per it's May press release following the meeting of the Governing Council and subsequent comments by Senior Deputy Governor Wilkins.

We have spoken previously about the ongoing lengthening of the benchmark duration. Now, a combination of lower yields, curve flattening, maturities shortening below one year and long-term issuance (particularly by governments) has lengthened the modified duration of the FTSE TMX Canada Universe Index to currently just shy of eight years at 7.95 years (as of June 4$^{th}$), and is projected to extend to a record 8.00 years by the middle of June. As we have explained previously, such low yields and a flat yield curve, makes the ownership of long bonds particularly unattractive on a risk-reward basis – noting particularly poor break-even yields for long Canada's. Index portfolios (including funds and ETF's) are particularly vulnerable given their requirement to match the duration and structure of the benchmark.

**Outlook & Strategy**

We still expect the US economy to deliver reasonable growth with tighter labour markets and higher wages throughout 2019. However, the challenging trade environment – we are not hopeful that there will be substantial progress anywhere – and consequent impact on global growth will likely necessitate the Fed's involvement. Canadian growth will be further impacted by a softer housing market and weak energy prices. We think it likely that the Federal Reserve will deliver at least one rate ease later this year; although they have generally guided for caution, we feel that the trade quagmire may leave them no choice but to act. We don't expect the Bank of Canada to follow unless the Canadian economy deteriorates significantly.

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, tight labour markets should eventually push inflation expectations higher, but given recent experience, we are hesitant to predict the timing of this move.

The environment should remain favorable for domestic investment-grade bonds as supportive monetary policy and durable credit metrics have reduced the risk of a disorderly selloff. We feel however that the risks remain elevated for more speculative credit classes, such as high yield, leveraged finance and emerging markets. Given the market's risk tolerance and capacity to absorb riskier debt outflows, there is greater probability that a repricing cycle becomes self-reinforcing.

**Gary Morris**, CFA
President

**Thomas Gomes**, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com