December 31, 2014

Focused Fixed Income

Market Highlights

The fourth quarter was much like the rest of the year with yields falling on the back of developing global events and supportive central bankers, despite strengthening of the US economy. Q4 returns, according to the ever-lengthening FTSE TMX Universe Index (now with a modified duration of 7.4 years, from 6.7 years last January), were 2.70% bringing the annual return to 8.79%. Provincials led, returning 3.90% for the quarter and 12.18% for the year according to the provincial index. Credit spreads widened in the final quarter, resulting in corporate bond underperformance, with returns of 1.87% in the quarter and 7.58% for the year, according to the corporate index. The best performing assets for the quarter and year were long governments at 5.69% and 17.88% respectively; long corporates returned only 3.78% and 16.12% for the same periods.

The catalyst for Q4's bond market rally was further deterioration of European economic prospects fuelling expectations for more European Central Bank QE and the collapse of oil prices. On-going problems in Western Europe – high unemployment and political instability in some countries, combined with problems in Eastern Europe (Russia) – weak energy prices and a falling ruble, to foment a decline in sovereign bond yields. Ten year Bunds ended the year at 0.54%, and even 10-year Spanish bonds fell below similar term Treasuries: 1.60% versus 2.17%. Crude Oil (WTI) prices fell (off a cliff) in Q4, dropping from $89.39 (WTI) to $53.27, reducing inflation expectations as shown by the spread between 10-year nominal and real bonds: 1.45% and 1.7% in Canada and the US respectively

The US economy continued to produce exceptional results in the second half of 2015, with Q3's GDP revision coming in at a lofty 5.5% annualised, stoked by strong consumer spending. Employment gains continued to be positive, averaging 267,000 over the last six months and 282,000 in the first two months of Q4. The US housing market was encouraging, although somewhat uneven; with both existing and new home sales trending higher and housing starts eclipsing 1 million on an annualised rate.

The Canadian economy's performance was more modest, with Q3 growth coming in at 2.3% annualised. The key drivers of the Canadian economy – housing and the energy sector, both slowed in Q4, with lower energy prices impacting both, and affordability also catching up with homebuyers. The Canadian export sector was a valuable counterbalance, although slowing in December, benefitting from the weak Canadian dollar and a buoyant US economy.

Portfolio Activity

With the weakening in corporate spreads, the portfolio opportunistically increased exposure (on a duration weighted basis) to telecom, senior bank debt and pipelines via a reduction in shorter-dated subordinated and senior bank debt. The overall shorter duration and higher credit quality bias of the portfolio was maintained.

What Worked In The Quarter

Relative to the index, the portfolio was significantly overweight provincial and corporates on a market value weighted basis providing yield enhancement, but underweight and neutral (for most of the quarter) respectively on a duration basis, thereby reducing sensitivity to yield spreads. The provincial exposure was concentrated in Ontario and Quebec which were the top performers for the quarter and year. Corporate spreads widened by 12 basis points on average during the quarter.

What Didn't Work In The Quarter

The portfolio was structured with a short duration via a concentration in the short-end of the yield curve in lieu of maturities 10-years and longer. For the quarter 5, 10 and 30-year yields fell by 29, 37 and 34 bps respectively.

Outlook & Strategy

We make several key observations: 1. The Fed has indicated it will likely begin raising rates sometime in Q2 (of course data permitting) recognizing the declining slack in the US labour market; 2. US economic data seems to support the Fed's plan given the trend of employment gains and the strength of the consumer; 3. Sharply reduced oil prices will create more stimulus than deflation; and 4. The US and particularly the Canadian yield curves are relatively flat.

We expect US overnight rates to begin to rise in Q2 this year, with Canadian overnight rates to lag significantly. Mid and long term yields in both the US and Canada will be forced higher, with Canada's again to lag – yield curves may flatten further, but absolute yields will rise across the yield curve none-the-less.

The portfolio will remain positioned for higher yields with a short modified duration and a concentration around the 5-year area. Higher quality credit spreads should remain relatively stable and hence the portfolio's provincial and corporate overweight's will be maintained.

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