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LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

There were definite headwinds for the US and Canadian economies when Q1 began, but we were relatively optimistic that the US consumer would shift into a higher gear on the back of consistent employment gains and a petrol dividend to drive US growth, with collateral benefit to the slowing, energy-sensitive, Canadian economy. However, weather is always a wild card for the economy, and this winter was again severe, with the detrimental impact to consumers and growth only gradually becoming clear. We will have to wait another quarter to see the full impact of healthier US consumer finances.

In Canada, tough winter conditions only added to the fallout from the beleaguered energy sector and the confidence-deflating ministrations of Governor Poloz, who recently described the Canadian economy as “atrocious” to a Financial Times correspondent during an interview. Economic data was decidedly negative, with the bright spots mostly coming from currency sensitive manufacturing exports and interest rate sensitive consumer spending. Although, in the case of consumer spending, further increases to consumer debt levels continue to be a concern for the Canadian economy, although evidently not for the Bank of Canada at this time.

During the quarter Janet Yellen continued a fairly predictable message of eventual rate increases within a framework of data dependency while attempting to mitigate volatility, albeit unsuccessfully, to the overall yield curve. In that context, 2-year US yields dropped from 0.67% to 0.58%, and 10-year yields dropped from 2.17% to 1.92% while bouncing between 1.64% and 2.24% during the quarter. In contrast, the Bank of Canada was mostly unpredictable, surprising investors first with a rate cut in January and then with indications of more to come, no more to come and finally maybe more to come. 2-Year and 10-year Canadian yields fell from 1.01% to 0.51% and from 1.90% to 1.36% respectively.

With bond yields at historically low levels, corporations continued their penchant for new issues, causing first quarter financing totals to eclipse last year’s Canadian market record: $26.1 CAD bln versus $21.6 CAD bln. As for investors, their thirst for new product seems bottomless, with the raft of new issuance having only a marginal impact on yield spreads.

Portfolio Activity

Post the Bank of Canada rate cut and resulting rally of short-term yields the portfolio was positioned for yield curve steepening further out the curve through a shift into mid-term bonds and reduction of lower-yielding short-term bonds and long bonds, while maintaining the overall short duration bias. The portfolio also opportunistically increased exposure (on a duration weighted basis) to senior bank, telecom and insurance bonds which had cheapened on the back of supply.

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. The portfolio’s credit quality (which increases with term) was positive, as spread widening from A to BBB-rated debt increased as one moved out the credit curve. Additionally, the portfolio’s overweight in Quebec provincial credit was positive with spreads tightening due to Quebec’s improving fiscal and financing position. Finally, although the overall duration of the portfolio was relatively short, the portfolio did benefit from a significant overweight in 5-years – the best performing area of the yield curve (on a yield basis).

What Didn’t Work In The Quarter

The portfolio was structured with a short duration and bias to yield curve steepening a concentration in the 5-year area of the yield curve in lieu of maturities 10-years and longer. While the curve did steepen, yields for 2, 5, 10 and 30-year Canada’s fell by 50, 63, 54 and 35 basis points respectively.

Outlook & Strategy

Although recent US economic data has soured, we fully expect a rebound in Q2 that will continue along the path of strong employment growth. We expect the Fed to continue to downplay its plans, but are still confident in our expectations for a rate increase late in Q2. The most recent Fed “dot plots” suggest a shallower path for short term rates, but we expect the whole US yield curve to gradually move upwards, albeit with a flattening bias. Of course, the extremely low level of yields in other developed countries will continue to exert downward pressure on US yields.

Canada’s current economic outlook is not particularly bright, but perhaps not as bad as Governor Poloz sees it. It has been difficult to interpret the Bank of Canada under Poloz, so we are not all that comfortable predicting the Bank’s next action. That being said, we are confident that any rate increase is very much into the future. We still expect the Canadian yield curve to steepen with the rise in longer-term US yields, although with a relatively shallow trajectory. We feel it appropriate to maintain a shorter duration than the benchmark, given our outlook and the benchmark’s lofty 7.5 years duration.

Given the easiness of monetary policy globally, capital should continue to remain liquid and thus generally supportive of the corporate bond market. Also, US economic improvement should have a steadying effect on spreads.

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