



LORICA | INVESTMENT
COUNSEL INC.

Short-Term Bond

Market Highlights

Most of the fourth quarter was spent anticipating the Fed's first rate hike in ten years, which eventually did come at the year's final FOMC meeting on December 15-16. Janet Yellen was clearly not going to risk a market misstep and therefore telegraphed the move with a host of FOMC members delivering well-coordinated speeches in advance which were designed to prepare investors for the increase. During the intervening period between October and December meetings: 2, 3, 4 and 5-year Treasury yields rose by 26, 28, and 27 bps respectively. Nevertheless, following the meeting, 2, 3, 4, and 5-year yields still managed to rise 4, 5, 5 and 6 bps respectively. The Fed was careful to moderate investor expectations for its next increase, with a reworded statement indicating "only gradual increases in the federal funds rate" and deliberate comments during Yellen's press conference.

Perhaps more important than the Fed's ministrations was the November data released subsequent to the December meeting. Manufacturing ISM and industrial production both showed outright contraction from October. However, non-manufacturing ISM is still over 50, indicating positive growth. More importantly, there is confidence in the domestic economy with November housing permits surging and consumer sentiment high.

The Canadian economy is, unfortunately, much more of a concern. The anticipated bounce in manufacturing in response to Canada's weakened dollar did not materialize in Q4 and looks to be limited to businesses more sensitive to US growth than to the currency - the summer trade balance improvement was clearly on the back of a temporary bounce in commodity prices. The Bank of Canada downgraded its growth projections in its October **Monetary Policy Report** and updated its **Framework For Conducting Monetary Policy at Low Interest Rates**. Investors responded by steepening the Canadian yield curve by 5 bps in the quarter and pricing in the slight possibility of another rate decrease by Governor Poloz.

The global picture remains challenging: many countries suffering from the decline in commodity prices; China's gradual reorientation to more domestic-led growth slow to gain traction; and Europe mired in economic and migration problems.

Portfolio Activity

On the back of widening credit spreads and the steepening of the credit curve, the portfolio opportunistically increased

exposure (on a duration basis) to senior bank debt while reducing exposure to subordinated debt. The portfolio's quality, duration and yield curve bias was maintained.

What Worked In The Quarter

The portfolio's corporate exposure was concentrated in higher yielding debt (as a source of alpha) in sectors which were top performers: senior and subordinated legacy bank debt – reduced issuance and liquidity premiums; telecom – solid earnings reports and Bell deleveraging; and auto debt – record sales. The portfolio had no exposure to underperforming oil and gas or energy generation issuers.

The portfolio was significantly overweight Ontario and Quebec provincial credit on both a duration and market weighted basis. The spreads of these holdings tightened 4 bps.

What Didn't Work In The Quarter

Relative to the index, the portfolio is more conservatively structured with a shorter-duration and an overweight in the 2 and 3-year area of the yield curve in lieu of 4 and 5-year bonds. For the quarter, underlying 2, 3, 4 and 5-year government yields fell by 5, 4, 6 and 8 bps respectively.

Outlook & Strategy

It will continue to be a tough environment to avoid capital losses in sovereign bonds and we will therefore maintain a bias towards credit. Although Canadian economic fundamentals will be challenging, there remains sufficient yield spread in short term corporates to protect against moderate spread widening.

We expect the Fed to continue raising rates cautiously in 2016 for a total of 3 or 4, 25 bps moves. The US yield curve will flatten modestly, while the Canadian yield curve will steepen, as short term Canada's will be forced to price in at least some probability of another rate decrease by the Bank of Canada. We ascribe a 50% probability of a further decrease by the BoC. The C\$ will continue to languish as energy prices remain weak and policy divergence between the BoC and the Fed grows.

The risk to our outlook lies mostly with the ability of the Fed to raise interest rates, which will be dependent upon the capacity of US consumers to lead the US economy. Strong job growth and signs of wage growth should support the consumer, but a strong US\$ coupled with weak export economies will forestall any significant improvement to the US trade balance.