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# What We Think…….

## Diverging Bond Markets – US & Canada

The Canadian bond market returned 3.52% in local currency in 2015, according to the FTSE TMX Canada Universe Bond Index (modified duration 7.44 years). The US bond market returned 0.55% in local currency over the same period according to the Barclays US Aggregate index (modified duration 5.68 years). Why the big difference? Well, over 2015, Canadian Universe yields fell 22 basis points from 2.23% to 2.01%, while US Aggregate yields rose 34 bps, from 2.25% to 2.59% - that is about a half percent swing between Canadian and US yields, from about the same starting point. Another way to look at the year for the two markets, is that investors in both markets started off with the same yield prospect (ignoring currency, which is a bit unrealistic but useful for this discussion) – US investors suffered about a 2% capital loss while Canadian investors made about a 1.3% capital gain, all in local terms.[1]

We make several observations when looking at the Canadian and US returns, beyond the actual performance: i. How little it takes to wipe out yield at today's levels, as was the case in the US; ii. The yield sensitivity embedded in the Canadian bond benchmark due to the long duration and large weight of long bonds; and iii. The degree to which the Canadian bond market is now *priced for perfection*.

Janet Yellen has started on a path to "normalize" interest rates (although precisely what "normalize" means is not universally understood) and has made it clear that the Fed will proceed cautiously with "only gradual increases in the federal funds rate". At the same time, the Bank of Canada (BoC) revised its economic projections for Canada in its October ***Monetary Policy Report*** downwards and updated its ***Framework For Conducting Monetary Policy at Low Interest Rates***. Of course, there are those that think the Fed will not be able to carry out its plans to raise rates, due to visible cracks in the global economy – we think the Fed will execute 3-4, 25 bp hikes in 2016.

The strength of the US economy rests mostly with the fortunes of the US consumer. Too much of the global economy is suffering from the fallout of the collapse in commodity prices for the US economy to rely too heavily on exports for an added boost (exports account for only 13.5% of the US GDP). Fortunately, the consumer has been finding jobs and leading domestic growth. To the extent that Canadian exports are levered to US growth, Canadian growth is also benefitting from US demand. However, the depreciation of the Canadian dollar does not appear to be generating the anticipated trade gains as the Loonie is not the only currency that has depreciated against the Greenback and currency-sensitive Canadian export capacity has greatly diminished since the 1990's.

Softness in the Canadian economy has a good chance of inducing the Bank of Canada into more action in the coming year.  We would question the wisdom of Canadian QE, notwithstanding the BoC's framework for unconventional policy, due to the already very low rate structure in place and our expectations of limited wealth effect from any BoC QE. (Although there has not been a Canadian version of QE, the Canadian yield curve has benefitted indirectly from QE implemented by foreign central banks, which has depressed sovereign yields globally.) We would expect the Bank to first try lowering rates, even to negative levels, before deploying large-scale asset purchases. (We are not conspiracy theorists, but we think that asset purchases would be an ideal complement to the financing needs of a burgeoning federal deficit.)

Out-of-sync monetary policies between Canada and the US is not new, and experience over the last thirty years suggests that divergences generally emerge when Canadian policy lags US policy, as is the case

[1] In simple bond math: a 35 bps rise times 5.7 years modified duration for the US Aggregate is approximately a 2% loss; versus a 22 bps decline times 7.4 years modified duration for the Canadian Universe which is approximately a 1.6% gain (slightly higher than the actual number of 1.3% due to the significant steepening of the Canadian yield curve and the large convexity effect at lower yields and longer durations).

**Gary Morris**, CFA
President

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

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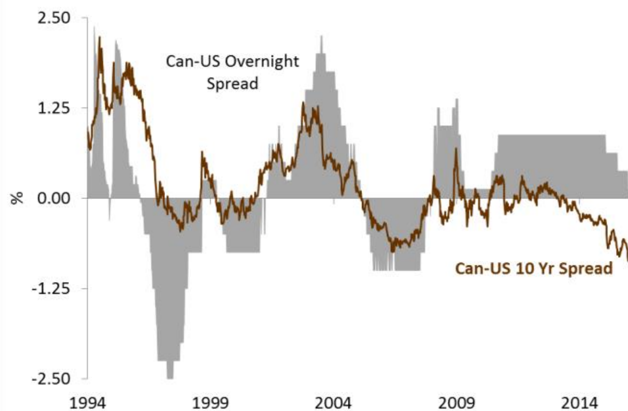
today. We expect the growing divergence to stretch yield differentials between the two countries, particularly in the short-end of the yield curve. Longer-term Government of Canada yields tend to follow US Treasury yields, irrespective of the underlying environment. There have been periods of far greater divergence between overnight rates than we have today (see Figure 1), however, we are now at the minimum yield spread between Canada and US 10-year government bonds and close to the minimum for 30-year bonds, of the last thirty years. Longer-term yield spreads will widen as the overnight differential widens, but we expect the amount of widening to decline moving out the yield curve.

**Figure 1: Canada-US Overnight Target Rate Spread**

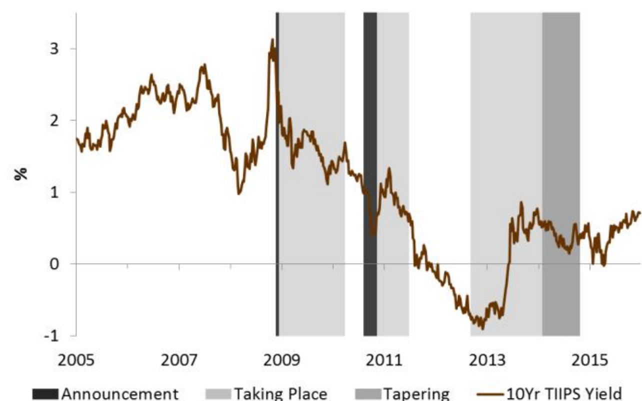



*Notes: Midpoint of Fed Funds Target Range used*
*Source: Bank of Canada, Federal Reserve & Lorica Investment Counsel Inc.; December 2015*

Looking back historically, the US Treasury curve has tended to flatten during periods of rising overnight rates. However, today's *rising rate* environment follows a period of unprecedented Fed intervention that has distorted, albeit deliberately, the shape of the yield curve (recall Operation Twist). While we expect the US yield curve to flatten with rising rates, the move will be muted. US real yields across all maturities have been artificially depressed as the result of extensive QE (see Figure 2), and though the Fed has stopped additional Treasury purchases, it is still reinvesting coupon and principal payments. We believe the Treasury curve is therefore flatter than would otherwise be the case, which will prevent investors from flattening the curve too aggressively as the Fed increases overnight rates, in anticipation of an eventual unwind of the Fed's balance sheet. Prior to the *Credit Crisis*, the last time the Fed Funds rate was at 1% was in 2003-4 when the US 30 vs 2-year yield curve was about 100 bps steeper than it is today.

The Canadian dollar has typically weakened when US overnight rates move higher than Canadian overnight rates. Granted, there are usually other factors that have a significant impact on the currency – today, it is the substantial decline in energy prices. However, we do not see a rebound in energy prices in the near term and expect the widening of the spread between US and Canadian overnight rates to place additional pressure on the Canadian dollar.

**Figure 2: US 10-Yr TIIPS Yield with QE**




*Source: Bloomberg, St. Louis Fed & Lorica Investment Counsel Inc.; December 2015*

## Credit Markets

Corporate credit had a mixed year in 2015, outperforming Government of Canada's in the short-end of the yield curve, but underperforming in the mid and long-ends. It was truly a year where the benefit of wide break-evens in the short-end of the corporate bond market was illustrated – short corporate yield spreads off Canada's widened a significant 39 bps (from 97 bps to 136bps on average), but not enough to cause short corporates to underperform short

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Canada's. Mid and long term corporate break-evens were (and still are) not wide enough to protect investors from spread widening in the mid and long parts of the yield curve. Looking ahead to 2016, break-evens have gotten larger, but the best protection still resides in the shorter part of the corporate yield curve (see Figure 3.)

**Figure 3: Break-even Yields[2] (bps) – FTSE TMX Canada Universe Bond Index**

| | Canada | Provincial | Corporate |
|---|---|---|---|
| **Short** | 22 | 36 | 68 |
| **Mid** | 17 | 30 | 47 |
| **Long** | 13 | 21 | 33 |

*Source: Lorica Investment Counsel Inc.; December 2015*

We expect credit spreads to continue to be volatile and exposed to liquidity problems. Bond market intermediaries, allegedly, are still retrenching from market making, while the amount of capital tied up in off-market trading continues to increase. At this point we do not have specific concerns over any one particular area, except note that there are potential problems in bond ETF's (particularly those with plenty of corporate content), high yield funds (with concentrations in energy issues), and REIT's (especially those with Alberta exposure).

The provincial bond market also deserves a mention for several reasons. Fundamentals have deteriorated in line with the challenges facing the Canadian economy which pushed provincial yield spreads wider in 2015. At the same time, provincial bonds have benefitted from the migration from lower quality corporates, resulting in sector outperformance.

There is now more pressure than ever on the provincial transfer payment system with more provinces in danger of becoming "have nots". The new *chumminess* between federal and provincial leadership will likely mean that the nation's premiers will cozy up to the prime minister with hands open. However, we don't expect that the federal government will be able to support the provinces for long, as it will have to deal with its own fiscal challenges, including commitments to infrastructure, climate policy, refugee support, tax changes and declining revenues from weaker GDP.

Notably, Alberta bonds, long the provincial darlings with far less issuance than sister provinces and backed by an economy that had habitually spun off substantial energy royalties, have been the worst performers, and now share space with Quebec and Saskatchewan.

## The World Economy

The fundamentals of the world economy are challenging, to say the least. Europe is stuck in an economic rut that has been years in the making. A Eurozone that was never structured to meet its potential is now mired in slow growth without real fiscal policy tools to fix things. Compounding matters is the refugee crisis, which is putting the whole *Euro* concept at risk, as borders are now emerging all across Europe, thus threatening the Shengen (open border) Agreement. At the very least, discussion of a "closer" Europe has been taken off the table for the foreseeable future. There are also still legions of unemployed youth in the most populous countries, except for Germany, although the new German immigrants will likely change that in the short term.

The ECB has stepped up with more QE, and more rhetoric, but as was the case in the US, business investment is still weak. Furthermore, ECB QE is proving less effective than the Fed at generating a wealth effect, due to the fragmented nature of its program (spread across various bond markets) and the divergence between US and European monetary policies. We expect European bond yields to remain low which will maintain downward pressure on North American yields.

[2] Break-even yields are the amounts that yields would have to rise in basis points (including yield spreads for credit), before generating negative returns, over a 12-month period.

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We would not over-react to the problems in Asia. Japan is, of course, still struggling to revitalize its economy, but is having difficulties – additional QE is really just more of the same without genuine prospect of change, when the route to change is embedded in Japanese behaviour and demographics. China could be more of a worry, but in terms of the US economy there is only minimal direct exposure (exports to China make up less than 1% of US GDP). Chinese exports are vulnerable to the world economy and have thus slowed as demand has dried up. Investors have responded by pulling capital away from the stock market which, ultimately, is more damaging to sentiment than the underlying economy. In response, the Chinese government has devalued the Yuan in an attempt to improve export market share, but this has been met by competitive devaluations elsewhere. However, more importantly, there are still plans to stimulate the economy through government spending, which we expect to pick-up pace in 2016, allowing China-concerns to fade from the headlines.

The Middle East continues to pose a threat to global stability, but this is not new – recall the *Arab Spring* of only a few years ago. What makes today's environment substantially different from the past, is the Middle East's declining influence on oil prices. (We are in agreement, however, with those who point out the waning influence of the US in the region and the consequent destabilising effect.) From an economic perspective, the most significant impact of current events will be on the continued ineffectiveness of OPEC to control prices, especially in light of renewed supply from Iran. Weak prices will continue to affect oil-dependent economies globally and put downward pressure on headline inflation in the short term.

***Ten Things to Watch In 2016***

1. *Fed Dot Plots – FOMC members are charting a far more aggressive rate hike course than the market.*
2. *Oil Prices – We don't think we have hit the floor yet, as control of Middle East supply is unlikely (Iran supply on the horizon) and global growth remains weak.*
3. *$Cad – Federal Reserve/Bank of Canada policy divergence will exert more pressure on the Loonie.*
4. *Canadian Government Deficits – Weak Canadian economic fundamentals and less spending restraint will result in larger federal and provincial deficits, which will impact bond prices.*
5. *Term vs. Credit – Yield versus duration exposure currently favours credit; watch break-evens, as investors will not be rewarded for moving out the yield curve.*
6. *Bond Market Liquidity – Reduced broker capital and more off-market trading has created liquidity problems in the corporate market; large ETF and high yield funds could be a problem.*
7. *US Election – An election is always a concern for the markets, but with polarized views on the Fed, health care and other issues, this election warrants added attention.*
8. *Central Bank Asset Purchases – The ECB, BoJ and Fed are buying 65, 57 and 18 $Billions of marketable assets a month in new and refinancing purchases; what happens when this slows materially?*
9. *Chinese Growth – Anything concerning the world's second largest economy are important, but we remain of the opinion that Chinese authorities are willing to step-up with more fiscal stimulus.*
10. *Eurozone Instability – The refugee problem is playing havoc with European borders and fueling more discontent amongst voters, already frustrated by fragile economies.*