March 31, 2016

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The bond market started the year well, supported by weak economic data, released in January. In the US, December retail sales were down and manufacturing continued its currency-induced slump; employment figures, however, continued to show steady gains averaging 227k per month over the first quarter, with the unemployment rate at 5% and the participation rate inching upwards. Canadian data was also poor across the board – manufacturing, housing and employment. Later in the month, the long awaited bump to Canadian manufacturing was finally confirmed with March's release of January's 1.9% mom increase in manufacturing output on the heels of December's 1.1% mom increase, contributing to a 1.5% yoy GDP increase for January.

After a weak start, economic data improved over the quarter, and it would seem that recession in either the US or Canada is a negligible possibility. We feel, given that the Fed appears close to its dual mandate of price stability (2% inflation) and full employment (albeit, not well defined), recession-like monetary policy is no longer warranted. However, the conclusion one draws from Fed Chair Yellen's speech to the Economic Club of New York in March is that of a Fed fearing deflation or even recession, and consequently ready to stall on its plans to normalise rates.

In Canada, Trudeau's government has delighted Keynesians everywhere with Finance Minister, Morneau's March "stimulus budget". Although, worthy of a recession (we didn't think it was a possibility to begin with), the budget is sure to accomplish other goals, while putting pressure on government issuance. The headline deficit number of $30 Billion will not likely be reached (the economy is not doing badly enough to require all the padding) but the ultimate number will still be high. Appropriately, the market has "priced-out" the possibility of further rate relief from the BoC, flattening the yield curve in the process.

Elsewhere, where the threats of recessions appear more real to us, monetary authorities have been aggressive. The ECB, at its March meeting, decided on a set of measures to move inflation higher including more negative rates. In Japan, which is once-again in recession, the central bank has increased the amount and term of asset purchases in an attempt to flatten the yield curve, after having already pushed rates negative, earlier in the quarter.

Canadian bond yields were volatile during the quarter, moving with US yields that have fluctuated with the uneven data and the vagaries of Janet Yellen and the Fed. Mid and longer yields ended the quarter below where they began but somewhere close to the middle of the lower range for the quarter. Yield spreads, under pressure at the beginning of the year, took relief from the Fed's back-pedalling. The Universe index returned 1.39%, with corporates (1.51%) and provincials (1.64%) outperforming Canada's (1.15%)

Portfolio Activity

We used the bear steepening of the Canada and provincial yield curves as an opportunity to optimise the portfolios yield curve, duration, and provincial exposures. The portfolio's overall credit quality and bias for a steeper yield curve were maintained.

What Worked In The Quarter

The portfolio benefitted from the sector distribution – the concentration in short term, higher yielding debt (as a source of alpha) in corporate sectors which were top performers: telecom & cable, senior bank and auto debt. There was no exposure to underperforming oil and gas or energy generation issuers. The portfolio also benefitted from being significantly underweight long provincial credit on a duration-weighted basis, given their spreads widened by an average of 4 basis points during the quarter.

What Didn't Work In The Quarter

The portfolio has been conservatively structured with a relatively short duration and an overweight in the 5-year area of the yield curve, in lieu of long bonds. For the quarter 2-year government of Canada yields rose by 6 bps and 5, 10 and 30-year yields fell by 16, 17 and 14 bps respectively.

Outlook & Strategy

We have walked back our expectations of the Fed for the calendar year, based on our understanding of Chair Yellen's positioning of the Fed. Although we believe policy and data should purport higher rates and yield curve, we begrudgingly accept that the Fed is most fixated on markets and market risk. (We have alluded to this before, although not embraced it entirely.) Global risks from weak economies in Europe, Japan, China, etc. and extremely easy monetary policies have caused the Fed to elongate its definition of gradual. A couple of rate moves should be expected, at most. In Canada, the central bank has been relegated to the backbench with the Department of Finance taking the spotlight.

We expect mid and longer-term yields to be largely range bound with an upward bias, and are currently somewhere in the middle to lower part of that range. We will look to take advantage of movements within the range. Supportive actions from the Fed and fiscal policy should help Canadian credit. We will continue to take advantage of opportunities within the corporate sector.

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