September 30, 2016

LORICA | INVESTMENT COUNSEL INC.

Short-Term Bond

Market Highlights

Yields took a pause from the steady decline of the first half of the year and moved within a relatively narrow range during the third quarter. Short Government of Canada yields (FTSE TMX Universe Index) were flat during the quarter, while short corporate and provincial yield spreads narrowed by 9 and 2 bps respectively over the period. Overall Short Universe Index returns were 0.45% on the quarter and 1.52% YTD, compared with the US Barclays US Gov/Credit Float Adjusted 1-5Yr Index returns which were -0.04% for the quarter and 2.65% YTD in local currency terms. The behaviour of the bond market during Q3 suggests to us that investors, who have become accustomed to relying on the Fed for complete guidance along the yield curve, are both divided and confused over the future direction of monetary policy and, hence, bond yields.

US data were disappointing but not awful: non-farm payrolls averaged 239,000 Jun-Aug. (not including Sep. revisions) and core inflation was 1.7% YoY to August according to the PCE Index ex Food & Energy. Canadian data was less heartening with employment showing slight losses and core inflation falling to 1.8% YoY (Statistics Canada CPI ex 8 volatile sectors). Overall, North American growth continues to be challenged with US GDP at 1.3% YoY (Q2) and Canadian GDP at a more troubling 0.9% YoY (Q2) and -0.4% QoQ (Q2).

Major central banks demonstrated a consistent capacity for sowing uncertainty amongst investors during Q3. Janet Yellen and Fed laid the groundwork for a lower for longer trajectory at Jackson Hole and then followed up with an aggressive nod to data dependency at the latest post-FOMC meeting press conference. Mario Draghi, after convincing markets that it would only be a matter of doing "whatever it takes" (with extensive QE and negative rates) has put further policy on hold while pushing aggressively for fiscal "actions by national governments…". And the Bank of Japan, who has shown an unending appetite for purchasing securities, keeps fiddling with the size and composition of its buying program resulting in yield curve volatility with global bond market implications.

As for the Bank of Canada, Poloz has kept communication to a minimum but has indicated a desire to wait for the initial results of the government's fiscal stimulus program. For what it is worth, there have been fleeting signs of export growth outside the energy sector on the back of the much-devalued Canadian dollar. The most recent data show gains, albeit uneven, in autos, industrial equipment and machinery, consumer products, and accommodation and food services (tourism).

Portfolio Activity

During a period when spreads were pressured due to supply and market volatility, the exposure to higher-yielding insurance (subordinated) and bank (senior, domestic, non-systemically important) debt was opportunistically increased via a reduction in bank (legacy subordinated) debt, which had outperformed. Additionally, the exposure to provincials was increased on a duration basis. The duration and yield curve bias were maintained.

What Worked In The Quarter

The portfolio's corporate overweight (relative to the index on both market value and duration weighted bases) was concentrated in higher yielding issues in sectors which were top performers: insurance, subordinated bank debt, telecom and pipelines. On average, short corporate spreads narrowed by 9 bps over the quarter. The portfolio had no exposure to under-performing issues in real estate and retail or to underperforming Government of Canada bonds.

What Didn't Work In The Quarter

The portfolio was not exposed to energy generation credit, where spreads tightened by 53 bps (retracing some recent spread widening) as TransAlta's slightly positive quarterly results reduced the likelihood of its credit rating being downgraded to junk.

Outlook & Strategy

In September, bond markets seemed to have hit a resistance point. There are doubts as to the efficacy of QE and negative rates, and questions surrounding the ability of central banks to go further. We detect reluctance from both the ECB and BOJ to extend policy further (although faced with recession, we think both would be willing to reload) and we expect both to push harder for fiscal action. Consequently, some of the downward pressure on longer term rates has dissipated and, we expect, will remain muted. As for the Fed, we believe the path is for higher rates and that we will see some action ahead, albeit restrained. However, the case for a relatively shallow trajectory for Fed Funds has been communicated and markets have already adjusted – another reason for less downward pressure on longer term rates. We expect the bank of Canada to remain on hold and therefore so should the front end of the Canadian yield curve.

We are positioned more defensively for a steepening yield curve, but will take advantage of excessive steepening. We still favour an overweight of corporates where the yield spreads and break-evens are attractive on an historical and relative basis. However, we will continue to take advantage of trading opportunities.

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