LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

"I don't want the Presidency. I'm going to help a lot of people with my foundation–and for me, the grass isn't always greener."
— Donald Trump, Playboy, March 1990.

A lot can change in 25 years… somewhere along the way Donald Trump changed his mind and will become president in a few weeks and is ready to dissolve his foundation. Over roughly the same period, treasury yields fell continually – 10-year yields dropped 85% from a 1990 peak of 9.06% in May to a trough of 1.36% in July, 2016 – but have now begun a gradual move upwards.

In September, Treasury yields appeared to hit resistance levels, prompting a backup that persisted until the US election in November – 10-year yields rose by 28 bps. Following the surprise Trump victory, treasuries continued their backup until the last week in December – 10-year yields rose by another 68 bps. With liquidity severely depleted and most market participants operating with skeletal staffs, the last week of the year saw a momentary respite from the dramatic Q4 sell-off – 10-year yields fell by 9 bps. Over the quarter 2, 5, 10 and 30-year treasury yields rose by 43, 78, 85 and 75 bps producing a market return of –3.84% for treasuries and –2.98% for US bonds overall according to the Bloomberg Barclays Bond Indices.

Government of Canada bonds tracked treasuries for the most part, albeit outperforming, particularly in the short end of the yield curve. Canada's returned –3.91% for the quarter, dragging down their returns for the year into negative territory at –0.30%. Provincials and corporates returned –4.85% and –1.82% for the quarter respectively and 1.77% and 3.73% for the year resulting in overall FTSE TMX Universe Index returns of –3.44% and 1.66% for the quarter and year, respectively.

We attribute the first part of the bond market sell-off to a combination of central bank exhaustion and improving US economic data. Capital markets have relied upon a steady diet of supportive monetary policies from the world's major central banks to maintain low yields and flatten yield curves. However, the price paid has been the gradual disappearance of future policy cushion and the deterioration of central bank balance sheets, while delivering disappointing results. In the US, more convincing economic data allowed the Fed to be more forceful with its signals for a rate hike in December. Investors, sensing greater resolve for tightening in the case of the US and the lack of conviction behind more easing elsewhere, took this as a signal to begin reducing bond exposure.

We attribute the second part of the bond market sell-off to a repricing of policy risk in the US. Contrary to what many commentators explain, we believe most of the move to higher yields was to account for more symmetrical pricing of fiscal and monetary policy risk, rather than mostly for positive expectations of Trump economic policies. For too long, investors been able to assume the support of monetary policy and the absence of fiscal policies. With the election and developing central bank back-drop, both of these assumptions appeared to be no longer valid.

Portfolio Activity

Post the American presidential election, the yield curve significantly bear steepened and the opportunity was taken to increase exposure to the belly of the yield curve via an increase in mid-term provincial debt and a commensurate reduction to short-dated provincial and municipal debt. The duration and yield curve bias of the portfolio were maintained.

What Worked In The Quarter

Relative to the index, the portfolio was more conservatively structured with a shorter-duration and an overweight in the 5-year area of the yield curve in lieu of long bonds. For the quarter, the yield curve bear steepened with 2, 5, 10 and 30-year government yields rising by 24, 50, 71 and 65 bps respectively.

On average, corporate spreads narrowed by 19 bps over quarter. The portfolio's corporate overweight (relative to the index on both market value and duration weighted bases) was concentrated in shorter-dated, higher yielding issues in sectors which were top performers: insurance, subordinated bank debt, pipelines and telecom. The portfolio had no exposure to under-performing issues in real estate, retail, and airport infrastructure.

What Didn't Work In The Quarter

The portfolio lacked exposure to lower-rated oil and gas or energy generation issuers such as TransAlta and Capital Power which outperformed.

Outlook & Strategy

We believe the path for the Fed is for higher rates, and will see more action, albeit restrained, in 2017. We also expect a higher trajectory given the likelihood of supportive fiscal policy in the years ahead; though it is difficult to predict time, scale and ultimate effectiveness. The yield curve has steepened from an artificially flattened position, and further optimism around growth would steepen it further. However, we would expect at this juncture to see more volatility to mid and longer term yields as investors try to grapple with the different policy scenarios ahead. Any steepening and flattening in the US will be exaggerated in Canada, given the immovability of the front end of Canada's yield curve.

We are still positioned defensively for a steepening yield curve. We favour an overweight in short term corporates, where the yield spreads and break-evens are attractive on a historical and relative basis. We will continue to look for trading opportunities to take advantage of market movements.

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