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What We Think.......

Time to Extend?

The Fed has told us that they don't expect to raise rates more than twice this year – they have a habit of overestimating. The Bank of Canada has gone more-or-less silent – they are happy to take a rest. The central banks of Europe and Japan and quite a few others are still quite actively trying to provide stimulus – the end is not in sight. So is this the green light to buy bonds and extend duration? We do not think so. We feel it is more like an amber light to take tactical positions and leave those strategic long calls for higher yields.

The modified duration of the Universe Index first crossed the 7-year mark in June of 2014 after getting close for a couple of years. At that time, the overall yield for the index was just under 2.5%; the combination of low yields and long duration of the Index implied an average 1-year break-even (rise in yields required to offset income over one year) of roughly 34 bps (assuming parallel shifts and no change in credit spreads). With Universe yields having fallen another 50 bps on average since then, and the index having extended another ½ year, the average 1-year break-even has fallen to 26 bps. To put the break-evens into context, over the past 12 months, the Universe yield range has been 53 bps.

Figure 1: 1-Year Break-even by Term & Sector

Yield (bps)		Term (yrs)						
		2	3	5	7	10	20	30
Canada		27	19	15	16	15	14	10
Provincial	BC	44	33	29	29	27	22	17
	Ontario	51	37	33	31	30	24	18
	Quebec	48	35	32	31	29	24	19
Corporate	AA	77	58	46	40	36	N/A	20
	A	103	73	54	47	42	34	24
	BBB	115	96	71	55	51	39	33

< 25 bps   25-50 bps   >50 bps

Source: FTSE TMX Global Debt Capital Markets Inc. & Lorica Investment Counsel Inc..; March 2016

Average portfolio yields and durations are useful for giving a rough quantification of risks and returns, but they inevitably mask the nuances of yield curve and yield spread risks and returns. As the break-evens for the overall Canadian market have declined by about $^1/_3$ over the last couple of years, so too has the break-even for long-term maturities. For example, a thirty-year government of Canada had a modified duration of 18.9 years and yield of 2.8% in June 2014 for a 1-year break-even of 15 bps. Today, the modified duration is 19.9 years and the yield 2% for a 1-year break-even of about 10 bps – a $^1/_3$ decline. While the break-evens for long Canada bonds were small 2 years ago, today they are ridiculously negligible. Ten bps of protection against a rise in long government yields over a 12-month period (the range over the last 12 months was 66 bps), does not adequately compensate investors for the risk inherent in owning these bonds, even with very bullish expectations.

No doubt, some managers have been advocating long positions in government of Canada bonds, confident that yields would follow US Treasury yields as they narrow the gap against other sovereign bond yields. However, the tiny break-evens for government bonds (see Figure 1) are inadequate against the current volatility inherent in government yields and no match for break-evens on offer from short corporate bonds.

The picture for long provincial and long corporate bonds is no more attractive. Long provincial break-evens average just below 20 bps, while AA and A corporates are between 20 and 25 bps, and BBB's average 33 bps. This is not much protection when one includes the additional volatility and risk inherent in long credit spreads. Although BBB's offer more protection, it is not much when one considers the 77 bps spread range of BBB's over the last year.

Bond Index durations vary significantly from market to market: the popular Barclays U.S. Aggregate index currently has a modified duration of 5.5 years, while

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the Merrill Lynch Pan-Europe and Japan Broad Market Indices have durations of 7.3 and 9.2 years respectively. Where investors are concerned, bond market indices can be somewhat arbitrary in that they generally reflect the public marketable debt outstanding and not investor goals or risk tolerances. We believe portfolio duration must therefore be in the context of market and investor risk and return and not just indices. The Canadian Universe Index duration is relatively long at 7.5 years – it was only 6.4 years in 2006 and 5 years in 1996 – and should not necessarily be the starting point for portfolio duration. A portfolio with a modified duration of 5 years at today's yields would imply 1-year break-even of about 40 bps, still small, but 50% more manageable than the 26 bps for the index portfolio.

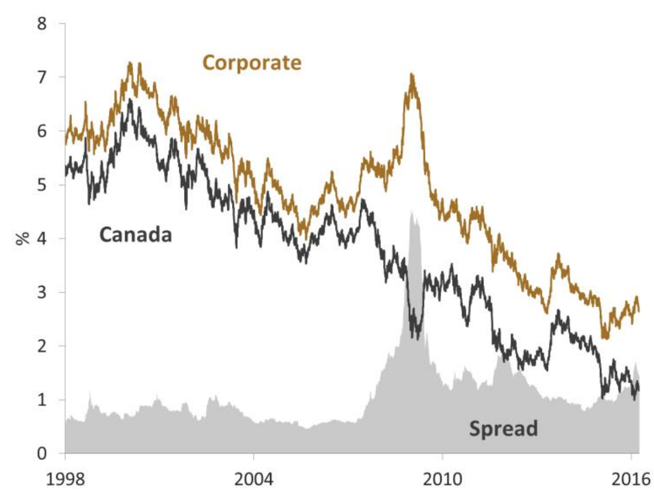
The current modified duration of our Focused Fixed Income mandates is about 4.5 years (or three years short of the duration of the Universe Index). Our position reflects the mandate, client risk tolerances as well as our strategic and tactical positioning. Strategically, we are of the view that yields are close to, if not at their bottoms, break-evens make it unattractive to own long duration bonds, and Fed monetary policy has begun to tighten. We have been early on this positioning, as the downdraft from European yields has been able to pull long US and Canadian yields down as well, but maintain that a short duration is appropriate and the index duration is far too long to be a starting point.

We acknowledge the Fed's desire for a "go-slower" approach to raising rates, although we feel that current economic data warrant a higher yield structure – the change in yields has become more important than the level of yields. We still expect yields to rise in 2016, but more slowly and of less magnitude. The US yield curve will likely have more of a parallel shift, but we maintain the Canadian yield curve will still steepen. However, consistent with our expectation for a shallower rise in yields, we will look for opportunities to take advantage of yield volatility with tactical duration moves.

Corporate Composition

Corporate yields spreads have been volatile, reacting to Fed expectations and the risk tolerances they provoke. Late last year, the Fed fanned the flames with a message of higher rates, finally capping things off with a December hike. Corporate bond investors did not respond well to the prospects of tighter monetary policy and consequently yield spreads widened substantially during the third and fourth quarters of last year. When rates finally rose, spreads continued to widen into the first half of Q1 of this year. However, as it became clearer that the Fed would slow its rate increases, yield spreads reversed course, narrowing back to the levels seen at the beginning of the year. We expect that spreads will continue to move with policy expectations, which will continue to be volatile.

Figure 2: Mid-Term A-Rated Corporate Canadian Yield Spreads



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The best risk/reward trade-off for credit continues to be in the short-end where yield spreads are wide enough to offer decent protection against spread volatility. In addition, we have preferred higher

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rated credits, where there is less spread volatility. Consistent with the overweight in 5-years and under bonds in our core mandates, we have a strategic overweight in higher quality short corporate bonds. We emphasize that we are not negative on corporates spreads, but recognize that expectations for tighter Fed policy will overshadow economic fundamentals, resulting in spread volatility.

Although there are uncertainties surrounding the Canadian economy, we do not see a recession as a likely scenario. We are comfortable owning short financial names, albeit acknowledging the challenges that low yields and a flat yield curve create. We are overweight communication, seeing the area as having relatively attractive yield spreads and reduced risk from M&A. Finally, we are underweight infrastructure credits, viewing this area as one of the most overvalued.

The Policy Vortex

The world economy seems to be stuck in a vicious circle reliant on state policies to sustain it. One cannot help but wonder if more policy only begets more policy, with little tangible progress? In command economies such as China and the Gulf States, one expects the government to dictate economic responses – and, to a large extent, this remains the case. In Western-style economies, where there has traditionally been a balance between policy-makers (governments or government agencies) and the private sector that varies by country and over time, we seem to be way out of balance. So much of what goes on today in capitalist societies seems to be under the direct control of policy-makers, with the private sector relegated further and further into the background.

There is no doubt that China adopted a market orientation commencing in the 1970's that has steered its economy in the direction of Western-style economies. However, the orientation is just that, an orientation, which means that its economy is still largely reliant on state planning and spending. Efforts to reform the Chinese economy to be more dependent on consumer spending have been unsuccessful. As infrastructure spending has been pared back, to help shift the economy while also addressing the reality of surplus infrastructure, growth has flagged. Consequently the government is once again boosting spending, as has become its custom, to reinvigorate infrastructure spending to maintain growth. Ultimately, high rates of economic growth is effectively a policy tool that the Chinese government has used to manage political dissent, and one that cannot be easily abandoned.

The economic situation in the Gulf States is particularly interesting, with Gulf countries forced to make policy decisions unique to their history. With energy prices having collapsed, and with OPEC rendered largely ineffective due to the emergence of a much broader range of oil suppliers, a near-term rebound in energy prices is less likely to be engineered. Consequently, Gulf States face the challenges of rapidly weakening economies that are creating huge government deficits. The reliance on monetary redistribution through government spending necessitates a large policy response from the state. Consequently, we are seeing the seeds of Gulf State debt financing and asset sales.

Closer to home, we have a US economy that has become addicted to Fed stimulus such that every attempt to move along the path to normalising interest rates is met with great angst and market volatility. While there are still many who believe the US economy is in need of more stimulus, a strong case can be made that recession-type interest rates are no longer warranted, especially given the Fed's dual mandate and the reality of today's levels of employment and inflation. The problem however, is how to get from the current level of interest rates (and balance sheet) to a level that is more consistent with the level of growth. The economy, and perhaps more precisely investors, have been fed a diet of low rates for so long, such that weaning them off has become problematic.

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While at one time, the Fed could be thought of as a massage therapist, where interest rates were concerned, its actions are now more like that of surgeon. (Except, if they were really surgeons, they would have been sued for malpractice by now.) The Fed's mandate has evolved throughout its history, from being more concerned with keeping the financial system operating smoothly, to now, keeping the entire economy operating smoothly. Controlling economic growth has become the Feds goals rather than controlling monetary aggregates. This is particularly noticeable in today's US economy where, due to excessive government partisanship, fiscal policy is largely unavailable to manage the economy, and hence the Fed has accepted the role of the last and only resort. (For what it is worth, successive Fed Chairs have stated a desire to see fiscal policy take the burden off monetary policy.)

Canada offers an interesting contrast with the US, with the newly elected Liberal government launching a very progressive budget that, for the time being, takes much of the stimulus burden away from the Bank of Canada. The Bank was able to stand back following the Credit Crisis, while the majority of developed countries had been providing stimulus, having benefitted from a more stable banking sector and high commodity prices. However, in the last year, Governor Poloz was extremely active in the face of weaker growth, dropping rates twice and talking down the Canadian dollar. The Liberal government's recent budget, which assumes a cumulative deficit of nearly $100 Billion over four years, has allowed the Bank to retake its place on the sidelines. It appears that in Canada, with a less contentious political environment, fiscal policy is still a viable proposition. In terms of infrastructure spending, there is less than what many had expected, and what there is, has been back-loaded. But it remains to be seen whether government spending will have the desired effect; although the Bank had close to exhausted its traditional levers for monetary policy anyways.

The Eurozone economy is another example of an economy increasingly reliant upon monetary policy, and where, fiscal policy is not a real possibility. The ECB, which does not have a long history from which to put today's environment in context, is nonetheless far more interventionist than likely ever envisioned by its creators. However, given the design and state of the Eurozone, the prospects for fiscal policy are not great, and thus the ECB has become the last resort for economic stimulus. And the ECB has become far more cavalier under President Draghi, and hence "nouveau" policies such as negative interest rates and indiscriminate asset purchases have been implemented liberally.

Finally, Japan. Mired in years of sub-par growth with recurring episodes of deflation – successive governments have implemented aggressive policies, both fiscal and monetary. Government debt to GDP has reached a massive 246%, and the BoJ's balance sheet, which sports 82% to GDP, is high, even when looking at the purchase hungry ECB and Fed. Japanese overnight rates are also negative at -10 bps on any new reserves. While the government and the BOJ, have been aggressive, consumers and businesses remain distant and impotent.

Unfortunately, what is missing from the solutions to the globe's economic problems is the advent of policies designed to transfer responsibility for the economy from policy-makers to the private sector. Even in the US, where traditionally there is much greater deference to the private sector, the private sector has become increasingly reliant on central bankers for stimulus, in turn, central bankers want to move responsibility to governments, and governments keep erecting more barriers for the private sector. Is there any surprise that global growth is subpar and falling?