June 30, 2016

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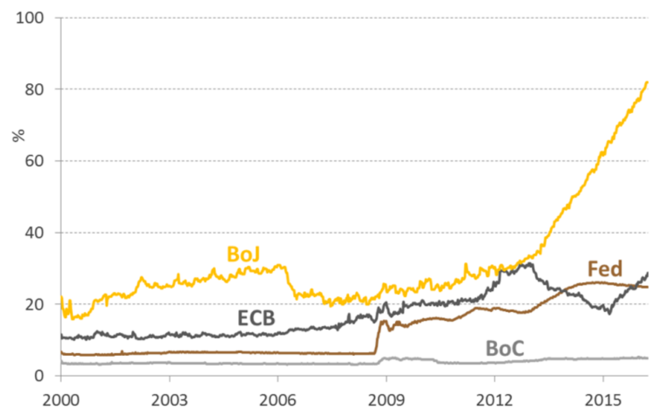
What We Think...

Keep Calm and Now What?

For the moment, the Brexit vote and the cloud of uncertainty emitted over Europe have roiled financial markets. Anyone who says they know what will happen next, with any amount of surety, shouldn't be taken too seriously. There is no precedent for the British referendum, exiting the European Union and the general discontent of EU membership (although the Union is trying desperately to appear united). There are plenty of possible scenarios, and if there is anything that we have learned watching Greece navigate its future in the EU over the last few years, is that the political machinations of the EU ensures unpredictability and surprises, often at the 11th hour. However, we will say with some level of conviction, that market volatility will continue to be elevated for some time, from levels that have already been elevated and aggravated by the lack of liquidity in many asset classes.

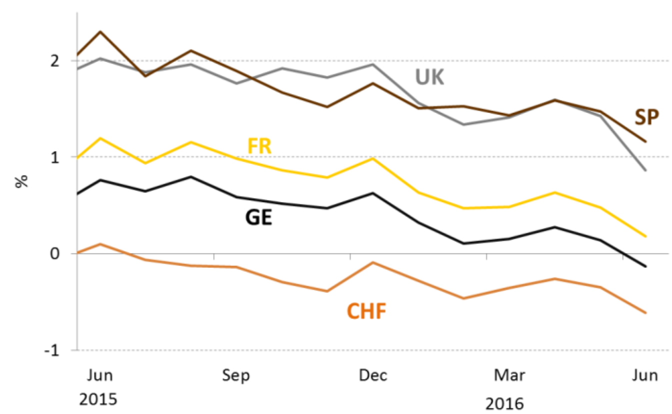
Figure 1: Central Bank Assets as % of GDP



Source: Bank of Japan, Federal Reserve, European Central Bank, Bank of Canada & Lorica Investment Counsel Inc.; March 2016

Bond yields have fallen since the vote, from already diminished levels. The German yield curve is now negative all the way up to 15 years and the Swiss yield curve is entirely negative. However, yields had turned negative well before the vote and well before investors began pricing in the risk of a "Leave" outcome. The European Central Bank has been actively expanding its QE program, to a level that has gone beyond the level of the Fed's QE program (on a GDP basis, see Figure 1), although far less than what has been implemented by the Bank of Japan. As ECB QE has expanded, European yields have fallen (see Figure 2), in turn dragging down North American yield curves. This tag-team between European and North American central banks and yield curves has been a constant theme over the last few years and will likely only stop when central banks exhaust their stimulus. In the meantime, Bank of England Governor, Mark Carney will likely also enter the fray, having warned, "monetary policy easing will likely be required over the summer."

Figure 2: European 10-Year Sovereign Yields



Note: CHF & GR begin in 03-30-2007
Source: Bloomberg & Lorica Investment Counsel Inc.; June 2016

So far this year, 10-year Bund yields have fallen by 76 bps and similar term US Treasury yields have fallen by 80 bps, while Canada 10-years have only fallen by 33 bps. Looking at US-Bund yield spreads (see Figure 3) suggests that only part of the Treasury decline was a "made-in-US" phenomenon (weak employment pushing Yellen out of the picture), while the balance was due to the safety and yield advantage of Treasuries.

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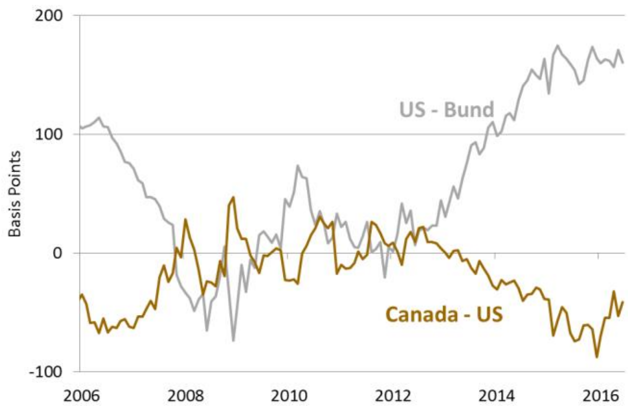
Figure 3: US-Bund & Canada-US 10-Year Spreads



Source: Bloomberg & Lorica Investment Counsel Inc.; June 2016

Looking at Canada-US yield spreads (see Figure 3) suggests that part of the Canada decline was a “made-in-Canada” phenomenon (weak growth amidst low oil prices), while the balance was due to Canadian yields tracking, but underperforming, the decline in Treasury yields. It has been a perfect storm for Sovereign bond markets, where domestic and international factors have conspired to force yield curves lower. First half and second quarter government bond market performances were stellar, with performance generally correlated with the overall duration of the market. Notably, Canada significantly under-performed other high quality sovereign markets despite having higher yields. (See Figure 4.)

Predicting the floor on bond yields has been a futile endeavor – central banks have continually shifted their targets and rationale, and have made “Zero Lower Bound” theories on nominal interest rates irrelevant. The combination of QE and negative interest rates has had a material impact on real yields and has interfered with the relationship between growth and nominal yields. With such low nominal yields, capital gains have been the principal driver of returns (although capital losses could easily generate negative returns) – year-to-date, the ratio of yield to capital gains for the Universe Index is about 1:3. The historical average for the ratio of yield to capital gain of the index is about 3:1, based on annual data over the last 30 years, excluding three years of negative returns. However, as long as central bankers keep spiking the punch bowl, there seems to be no end to the capital gain potential of the bond market.

Figure 4: Sovereign Bond Market Returns

	3 Months		6 Months		
	Yield Change (bps)	Return (%)	Yield Change (bps)	Return (%)	Modified Duration
Germany	-27	2.9	-62	6.8	7.8
UK	-44	6.5	-86	12.0	11.7
US	-21	2.2	-64	5.7	6.6
Canada	-14	2.0	-18	3.1	7.4
Japan	-20	2.8	-51	7.1	9.5

Source: Bank of America Merrill Lynch Global Index System & Lorica Investment Counsel Inc.; June 2016

We would concede that the Fed has, in reality, had only limited opportunities to raise rates over the last few years unencumbered, but have not had the courage to take most of those opportunities – having been scared off by panicking investors who have overreacted to any hint of policy reversal. Unfortunately, investors have been conditioned (intentionally) to be overly concerned with the change in rates, rather than their level, and hence have largely ignored the relationship between real yields and economic fundamentals. In the US, through ZIRP, forward guidance and QE, investors have generally responded to easier monetary policy with a zeal for risk – recall the constant vacillating over unemployment targets by the Fed in order to lend ongoing support to capital markets. For the time being, we believe the Fed is unable to move from current rates, as current economic and market conditions are unlikely to easily support any market backlash – the level of rates will remain secondary to any change of rates.

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What about the slope of North American yield curves? Aided by QE policies, NA yield curves have flattened precipitously this year (see Figure 5). The last time the US yield curve was this flat was January 2008, not long after a long period of rate increases by the Greenspan Fed that led to an inverted yield curve in 2006. Overnight rates were lowered aggressively during the credit crisis, causing the 30-2's UST Treasury curve to steepen to a historical high of 4% in early 2011, only to subsequently flatten by nearly 250 bps to today's levels. Since 2011, the flattening of the Treasury curve has been the result of diminishing inflation expectations (5-year, 5-year forward US inflation expectations have fallen by about 120 bps), a further decline in real yields (10-year TIPS yields have fallen by about 100 bps), and the Fed pitching in with a miniscule 25 bps increase. However, this year's flattening of 40 bps (30-2's, to date) has been mostly about the decline in real yields orchestrated by central bankers. Ten-year TIPS yields are down by a whopping 80 bps (to June), while growth expectations have fallen by about only about 20 bps (according to Bloomberg's GDP survey of economic forecasters) and inflation expectations are virtually unchanged (according to the St. Louis Fed's 5-year, 5-year Forward Inflation Expectation Rate).

Is the US Treasury yield curve telling us that we should be raising the probability of a recession in the US, and likewise Canada? There is no question the world looks a much weaker and more uncertain place than when the Fed raised rates in December of last year. Ongoing weakness in Europe had prompted downgrades to European growth forecasts (IMF) well before the likelihood of a Brexit outcome became a possibility. Similarly, Japan and Emerging Markets ex-China all received downgrades to their outlooks earlier this year. Add to this the apparent downward trend in US employment, and there is reason to be cautious on the continuation of the 10-year recovery. However, we do not think the data is weak enough to suggest recession, nor have we seen signs of a big enough shock to cause one (we do not think Brexit is a "Lehman" moment). Most importantly, although central bank policy has contributed to market uncertainty, in the bigger picture they are more likely to provide supportive policy that still has the ability to prop-up asset prices. So, no, we do not believe that yield curve is signaling anything more than central bank manipulation of long-term yields.

Figure 5: US & Canada Yield Curve Slope (30's-2's)

Source: Bloomberg & Lorica Investment Counsel Inc.; June 2016

In terms of the Bank of Canada, Governor Poloz has been quieter than usual this year, likely content to remain in the shadows of the federal government's fiscal policy. (As an aside, central bankers, who were rock stars coming out of the credit crisis, seem to have fallen out of favour – Draghi, Yellen and now Carney all have more vocal critics than usual.) We do not think there is anything for the Bank of Canada to do at this time – the domestic economy will muddle along at a tolerable clip. There are problems, however: the weaker loonie and disappointing US economy have not been enough to stimulate exports; the energy sector, with low prices and significant policy changes (carbon, pipelines, etc.), cannot be counted on for growth; and the real estate sector is stretched. At least consumption, while volatile, can still be counted on to contribute to growth, despite wages having stagnated.

We are now witnessing the lowest bond yields in history, without a clear bottom in sight. Market uncertainty and monetary policies, coupled with the flight to quality and a reach for yield have aggressively driven down levels. Notwithstanding the recent trend, the bond market does however, have substantial embedded risks. Low yields combined with lengthening duration risk have diminished the defensive characteristics of the bond market. The inherent convexity (sensitivity of duration to a change in yields) of long bonds results in a continually lengthening of duration in the long end – which means more risks for those investors tied to benchmarks with long exposure. We reiterate that Canadian investors closely tracking the Universe Index are particularly exposed to duration risk, given the index's modified duration is now at the longest it has ever been at 7.8 years – about equivalent to the duration of a 9-year Canada bond. Contrast this with the Barclay's US Aggregate at only 5.5 years. The average duration of the portfolio is about 4.5 years – closer to that of a 5-year Canada bond.

We believe the corporate market still offers good opportunity – the majority of corporate yield comes from the yield spread, making the risk/reward equation relatively more attractive for corporates. This is particularly true for short corporates where yield spreads account for roughly 2⁄3 of the overall yield, declining to less than 1⁄2 in the long-end. (Note, as mentioned above, long maturity bonds have seen their durations extend with lower yields, far more than for short maturity bonds, making the risk/reward proposition that much better for short corporates.) Corporate spreads have seen limited widening year-to-date, not nearly enough to offset the pick-up from relatively wide spreads, and consequently corporate bonds have outperformed. During January and February, yield spreads had widened considerably with prospects for Fed rate hikes at their greatest. As employment gains waned, the likelihood of Fed rate hikes this year faded, and interest in risk assets, along with the move in corporate yield spreads, reversed. As has been the pattern since the credit crisis, corporate fundamentals have taken a back seat to Fed policy and its support for riskier assets. In the current uncertain environment, we cannot see the Fed risking asset prices by credibly putting rate hikes back in play. Of course, should employment growth sustainably accelerate, the Fed would change its tone, although not necessarily its substance.

Our preference has been for maintaining above average corporate credit quality with mostly AA and A-rated bonds and some holdings of higher yielding BBB-rated credits of shorter term. From a long-term perspective the spread between short-term BBB's and A's at 50 bps is just below the historical average (of the last 30 years) of around 65 bps, but taken as a percentage of the overall yield, it is obviously now much greater. Generally, the BBB-A spread has been directional, although with current market uncertainty, there has been more volatility. In addition, BBB-rated issues now make up 1/3 of the corporate sector, another factor contributing to the risk and volatility of the domestic benchmark. We continue to be very selective on lower rated names, preferring to avoid issues with limited secondary market liquidity. We have seen how sensitive credit spreads can be to Fed policy expectations and are therefore content to avoid temptation to reach for yield particularly further out the yield curve.

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Globalization, Technology, and Monetary Policy…

At the time of the credit crisis, it appeared that it could be the end for capital markets as we knew them – the banking system was seizing up, investors were panicking and liquidity was disappearing fast. It required the injection of a massive amount of liquidity from central banks and the support of governments to keep the markets going and ultimately the global economy functioning. In terms of monetary policy, what began as a reaction to a crisis actually formed the basis of a new environment that has lasted until today. In the beginning, policy was entering new territory and there were many skeptics: initially it was about the seeds of inflation that were being sewn; later it was about the addiction that investors were developing for cheap money and how difficult it would be to wean them off of it. In general, there was a belief that unconventional monetary policy would likely have negative unintended consequences.

It is not possible to know how things would have turned out had the Fed and other central banks limited their unconventional policies including forward guidance, QE and negative rates. Emerging from the Great Recession, developed economies have not had traditional recoveries. However, we can reason that at least some central bank policies have contributed to underlying socio-economic developments that have created challenging environments in many countries around the world. In broader terms, globalization and technological change over the last twenty years have had significant impacts on the structure of developed economies and more specifically labour markets – both have resulted in a decline of well-paid blue and white-collar jobs, with the creation of more service jobs: either well-paying for the well-educated and well-connected, or not-so-well-paying for everyone else. The Great Recession (of which we in Canada were spared, for the most part) only added to the employment trends that were already in place. In many developed countries, building booms (which had softened the secular employment trends) seized and together with other failing sectors contributed to an acceleration of job losses. The global recovery since the recession has been tepid, as it has taken substantial time to recover jobs and generate tangible wage increases.

Government, business and household balance sheets continue to be in relatively poor shape, albeit with some improvement over the last few years. Households are still feeling the burden of heavy debt loads, property depreciation and income stagnation. In terms of the overall population, the working-age cohort has been the most severely impacted. However, the cohort of recent graduates has also had their challenges – they are disproportionately unemployed and in many cases suffer from high levels of student debt. Finally, the cohort made up of retirees is now also struggling, as they watch their ability to save decline with the decline in interest rates and bond yields (yes, equity valuations have been propped up, but retirees tend to be over-weighted in fixed income and focused on yield and capital preservation). It is not hard to see how we have arrived at a point in time where many voters are unhappy with the status quo and willing to take chances to upend it. Unfortunately, central bankers have unwittingly contributed to the current state, with limited ability and perspective to change it. (And we have not even mentioned how monetary policies have facilitated larger government deficits that will inevitably handcuff future generations).