March 31, 2017

LORICA | INVESTMENT COUNSEL INC.

Short-Term Bond

Market Highlights

Bond yields continued to trade within ranges established during the quarter throughout March. US Treasury yields traded within about 30 bps ranges along the curve, with yields finishing the quarter much where they started, in the middle of the range. Government of Canada yields also traded within about 30 bps ranges during the quarter, except for the very short-end where divergent monetary policies, between Canada and the US, ensured that the front-end of the Canadian yield curve was less volatile – 2-year's traded within only a 13 bps range.

Perhaps tired of playing second fiddle to the White House, the Fed upped the ante on monetary policy with a rate hike and dot-plot revisions at its mid-March meeting, followed by a series of hawkish statements from FOMC members. The immediate fall-out was the peak in yields just prior to the policy statement.

While sentiment towards the economy has been extremely positive, actual economic data has not been as convincing. Service and manufacturing surveys and consumer sentiment indices have all posted extremely strong numbers, while much of the underlying economic data has been mixed. Employment: January and February employment gains were strong (Non-Farm payrolls of 238k and 235k), but March expectations are mixed (ADP surprised at 263k). Consumption: housing data has steadily increased, but retail and auto sales have been disappointing – overall retail sales ex auto and gas were weak in February and are expected to remain so in March. Industry: perhaps the biggest news has been the contraction in commercial and industrial loans, at a pace not seen since December 2008.

In terms of sentiment, US service and manufacturing releases have been generally better than already up-beat estimates with both regional and national surveys posting increases. Consumer sentiment has perhaps been the biggest surprise with both Conference Board and Michigan data series on strong uptrends. Notably, the Conference Board's Consumer Confidence Index hit a 16-year high (125.6) on the back of labour and equity market expectations. We feel that the strong sentiment numbers have provided cover to the FOMC to adopt a more aggressive policy stance, being less concerned of a negative market response.

In Canada, data released in Q1 depict an economy in better shape than commonly assumed. Employment numbers have surprised to the upside, suggesting the economy has rebounded from low energy prices and responded to a lower Canadian dollar. Manufacturing, which has been very slow to show gains, delivered a robust 2.7% yoy increase in sales to January – although petroleum and coal products showed a 37.4% increase, there were also substantial gains from food and beverages, wood and paper products, chemicals, plastics/rubber, steel and machinery.

Portfolio Activity

The portfolio was optimally structured on a duration, yield curve and sector basis relative to our interest rate and sector forecasts, therefore trading was limited to the reinvestment of maturities and coupons into shorter-dated corporate debt.

What Worked In The Quarter

Relative to the index, the portfolio was overweight corporate debt. On average, short-term corporate yield spreads narrowed by 14 bps over the quarter. The portfolio's corporate exposure was concentrated in shorter-dated, higher yielding issues in top performing sectors: insurance, autos and subordinated bank debt. The portfolio was underweight infrastructure and utility issues, which lagged.

What Didn't Work In The Quarter

Relative to the index, the portfolio was more conservatively structured with a shorter-duration. For the quarter, government 1, 3, and 5 year yields fell by 1, 6, 8 bps respectively.

Outlook & Strategy

Our expectations for the Canadian bond market are still for a steeper yield curve, with relatively stable very short-term yields and higher long-term yields. Yields in the front-end of the yield curve (one and two years) will not move significantly, consistent with no policy moves from the Bank of Canada who will continue to site enough uncertainty to remain on hold – US trade and taxation policy changes are amongst the most important – while being content to watch the Loonie weaken against the Dollar as the Fed raises rates. Yields in the long-end will move higher with US yields, despite a Treasury curve that has been flattening. Although equity markets may be pricing in too much fiscal policy success – translating into some bond market weakness, we do not feel that overall, bond markets are too optimistic. Government yields have consolidated around ranges, and a move to higher yields will be dependent upon labour markets, inflation and the Fed. We are finally ready to take the Fed more seriously with respect to their predictions for interest rate hikes – noting the broad communication of the possibility of 3-4 hikes for the year.

We feel there is an increased risk for corporate spreads to come under pressure in the near term, given the potential for higher interest rates and the supportive supply/demand imbalance to reverse. However, corporate spread levels currently represent almost half of all-in-yields and thus still provide good relative value and protection. The portfolio possesses good liquidity and is structured conservatively with minimal exposure to sectors or issuers that would be most negatively impacted in the event of higher interest rates.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com