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LORICA | INVESTMENT COUNSEL INC.

Short-Term Bond

Market Highlights

The big story in Q2 for Canadian bond investors was the Bank of Canada's unexpected about-face on monetary policy. Governor Poloz, who, after choosing to stay in the shadows while political, economic and market uncertainties sorted themselves out, reappeared by proxy, somewhat prematurely, in a speech delivered by Senior Deputy Governor of the BoC, Carolyn Wilkins on June 12th to The Associates of the Asper School of Business, shocking the market with hints of reduced monetary policy ahead. Her message was echoed by other members of the Bank's governing council, including Governor Poloz in a CBC interview the next day, leaving no doubt of the Bank's intentions, and even urgency. Investors took heed adjusting the Loonie – rose by 2.9 cents against the US dollar, and the yield curve – 2-year yields rose by 35 basis points, after hovering around 0.75% since December (all to quarter-end).

European central banks were also active in June with ECB and Bank of England, both surprising investors with indications of tighter monetary policy on the horizon. However, to date, the Fed has been the only one raising rates, having moved another 25 bps on June 14th, together with the unveiling of its plan for unwinding its balance sheet in the near future.

Not surprisingly, sovereign yields were volatile, as investors responded to the idea of tighter monetary policy and lower inflation expectations. US and Canadian yields, were particularly volatile as investor confidence felt the effects of a Trump presidency floundering under the cloud of Russian election interference suspicions, the Comey firing and general POTUS policy stasis. German, British and other high-grade European yields rose during the quarter reflecting emerging confidence in respective economic prospects. While the rise in longer-term Bunds and Gilts impacted North American yields, the combination of disappointing US economic data and fiscal policy prospects was enough to force mid and long-term US yields lower. In Canada however, the revised stance of the BoC resulted in higher mid-term yields.

Second quarter Canadian Short index returns were -0.42%, +0.54% until Wilkins' speech and –0.95% thereafter. 1, 2 and 5-year yields rose by 32, 31 and 26. The Canadian 91 Day T-bill Index return for the quarter was 0.09%. Corporate spreads held firm during the period such that corporate bonds outperformed governments in the short-end of the yield curve – short corporates returned -0.27% versus -0.59% and -0.37% for Canada's and provincials respectively.

Portfolio Activity

In anticipation of higher rates the duration of the portfolio was gradually reduced through the reinvestment of maturities and coupons into short-dated corporate debt. The portfolio's steepening yield curve and credit quality bias were maintained.

What Worked 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 rose by 32, 31 and 26 bps respectively.

Relative to the index, the portfolio was overweight corporate and provincial debt. The portfolio's corporate and provincial yield spreads narrowed by 7 bps, on a duration-weighted basis, over the quarter. The corporate exposure was concentrated in shorter-dated, higher-yielding issues in top performing sectors: telecom, media, insurance, and subordinated bank debt. The portfolio had no exposure to real estate issuers or mortgage lenders.

What Did Not Work In The Quarter

The portfolio was overweight auto credit which lagged. The credit spreads of the portfolio's auto holdings narrowed by an average of 3 bps over the quarter.

Outlook & Strategy

We have had to change our outlook for the Canadian bond market in response to the Bank of Canada's rapid about-face, but will not have to alter our strategy. Prior to Senior Deputy Governor Wilkins' speech, there was no evidence of a shift in sentiment from the bank, despite the data having already improved – the message had been too much uncertainty. Clearly the Bank now believes that they have to get on with things – they can no longer ignore the better Canadian data, and have likely reduced the probability of Trump policies being enacted (although unlikely to say so). We expect the Bank to move once or twice this calendar year. The front-end of the Canadian yield curve has already responded to the Bank, but we expect more movement upwards following a Q3 rate hike.

We expect the back-end of the Canadian yield curve to catch-up with the rise in the front-end – both US and Canadian yield curves are too flat in our view. However, a further rise in longer-term NA yields will be dependent upon rising wages and inflation expectations, and central bank actions. We expect the Fed to be active with a combination of balance sheet reductions and rate hikes – likely one more. Investors appear to now, be pricing in low probability of a Trump growth dividend – admittedly, it is difficult to see this sentiment shifting any-time soon. We are positioned for higher yields and a steeper curve – which is still appropriate.

We feel there is an increased risk for corporate spreads to come under pressure in the near term, given the potential for the supportive supply/demand imbalance to reverse and the prospect of higher interest rates. However, corporate spread levels currently represent almost half of all-in-yields and thus 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.

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