September 30, 2017

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The trend to higher yields in Canada continued in Q3, propelled by Bank of Canada actions and communication. Short-term yields led the move higher, beginning with BoC senior deputy governor Carolyn Wilkins hawkish statements in June – catching most investors off-guard, followed by an increase to the Bank's policy rate on July 12th. With another hike on September 6th, the Bank's experiment with "near-ZIRP" is now over, with the last of the relatively short-lived insurance rate reductions from 2015, having been completely reversed.

Longer-term Canada yields have lagged the move higher, held back by benign inflation expectations and stubborn global sovereign long-term yields. While both Canada and US yield curves have tended towards flattening, the move has been extreme in Canada, with the 2 vs. 30-year Government of Canada yield curve forty basis points flatter than the comparable Treasury curve. Although Canada and US policy rates are now identical, we believe that anticipation of the Fed's balance sheet reduction plan is placing added pressure on long-term US yields.

Sovereign bonds performed poorly during the quarter, given insufficient income to offset capital losses from rising yields, with longs (-4.09%) the weakest (despite a flattening yield curve), ahead of mids (-1.48%) and shorts (-0.45%) according to the FTSE TMX Universe Index. Credit spreads did offer some protection for rising yields, although not enough to generate positive returns. Short corporates (-0.27%) and provincials (-0.45%) faired the best, followed by mid corporates (-1.11%) and provincials (-1.42%). Long provincials (-4.14%) and corporates (-3.58%) were hit especially hard due to the rise in underlying Canada yields.

The over-riding macro theme to emerge in Q3 was the perseverance of North American central bankers despite, not entirely convincing economic data, e.g. marginal wage gains, volatile manufacturing data, and below-target inflation. In the US, there was the additional consideration of diminishing policy expectations from the White House. Nevertheless, data was strong enough in both countries to convince policy-makers to continue their move to rate normalization.

Portfolio Activity

The portfolio was optimally structured on a yield curve and sector basis relative to our interest rate and sector forecasts, therefore trading was limited to the reinvestment of coupons into existing positions where needed.

What Worked In The Quarter

The portfolio has been positioned for rising yields and a steeper yield curve with an overweight in the 5-year area of the yield curve in lieu of long bonds. Over the quarter 2, 5, 10 and 30 years yields rose by 39, 32, 35 and 34 bps.

The portfolio's credit exposure was overweight shorter dated, higher yielding issues in top performing sectors: insurance, media, senior debt of non-systemically important domestic banks and Alberta debt.

What Did Not Work In The Quarter

The portfolio is structured with a more conservative, defensive bias relative to the index and as a result has a lower running yield. This yield drag has been partially offset by the overweight exposure in short-term credit where break-evens are more attractive.

Outlook & Strategy

We expect both the Fed and BoC to raise rates one more time this year despite both having qualified their actions, late last quarter, through their respective emphasis on the data dependency of future decisions. The Fed will also commence its schedule of balance sheet reduction. We expect yield curves to steepen in both countries led by the Treasury curve. We will consequently retain our short position with a bias to steepening.

Corporate spread levels represent a significant portion of all-in-yields and thus provide good relative value and protection. The portfolio possesses good quality and 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.

However, there remains a risk that corporate spreads will come under pressure, given the potential for the supportive supply/demand imbalance to reverse (including the appetite for lower quality credits), as well as the prospect of higher interest rates.

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