September 30, 2017

LORICA | INVESTMENT COUNSEL INC.

Short-Term Bond

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.

The rise of short-term Government of Canada yields during the quarter was significant, with 1, 2, 3, 4 and 5-years yields rising by 37, 40, 36, 31 and 32 basis points respectively. Higher Canada yields resulted in negative returns across all sectors despite relatively attractive break-even protection of shorter-term bonds, particularly corporates. Q3 returns were -0.45% for both Canadas and provincials and -0.27% for corporates according to the FTSE TMX Short-Term Index.

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

In anticipation of higher rates the duration of the portfolio was gradually reduced through the reinvestment of maturities and coupons into short-dated senior bank 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 short duration. For the quarter, short-term Government of Canada yields rose an average of 38 bps.

The portfolio's corporate exposure was concentrated in shorter-dated, higher-yielding issues in top performing sectors: insurance, telecom, pensions and media debt. The portfolio had no exposure to infrastructure or utility debt which underperformed. On a duration weighted basis, the provincial holdings were concentrated in Alberta, Manitoba and Quebec issues which were top performers.

What Did Not Work In The Quarter

There were no significant negative factors impacting the relative performance of the portfolio over the quarter.

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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