December 31, 2017

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The Canadian bond market eventually saw some profit taking or investor angst (or more likely both), as bond prices finally pulled back in December from their steady Q4 march upwards. Two, five, ten and thirty-year bond yields rose by 29, 27, 22 and 16 bps from their lows. The yield curve (2-30's) steepened by 5 bps to 58 bps from its flattest, but is still extremely flat on a historical basis. The FTSE TMX Canada Universe Bond Index returned 2.0% for the quarter (Oct. 1.6%, Nov. 0.8% & Dec. -0.4%), with the strongest quarterly returns easily coming from the long end – Short, Mid and Long returns were 0.3%, 1.1% and 5.2% respectively. The best performing sector for the quarter was long provincial bonds at 6%, with the worst performing, short Canada's at 0.12%.

Short term Canadian yields continued to be volatile in Q4, as the Bank of Canada delivered mixed signals with respect to any future increases in the remainder of 2017 and into the new year. The Canadian consumer has proved to be extremely resilient, supported by low rates and a surprisingly robust jobs market, giving the Bank further opportunity to normalize rates. Exports remain a concern for the Bank of Canada, having slowed in the second half of the year (-1.8% Jul.-Sep.), albeit showing some signs of life in the latter part of Q4 (2.7% since Oct.).

The US bond market generally set the tone for the longer end of the Canadian bond market in Q4 as investors finally understood that bond prices left little margin for error in terms of inflation expectations, real yields and term premiums. Investors had been willing to extrapolate low inflation and wage pressures into the future, despite historically low US unemployment levels (4.1% at the end of Dec.). The St. Louis Fed's 5-year, 5-year forward expectation rate had troughed for the year at 1.8%, although it has risen to 2.1% by year-end. Despite the Fed's balance sheet reduction plan, real yields spent most of the year at extremely low levels. 5-year TIPS yields hovered around zero until September, then rose to about 50 bps by year-end; however, long-term TIPS yields, having spent most of the year at around 1%, subsequently fell to 85 bps. Skepticism around the strength of the US economy and continuation of ECB and BOJ's QE strategies have ultimately had a depressing effect on term premiums.

Corporate yield spreads tightened by about 9 bps across the yield curve during the quarter, representative of the broad-based risk-on sentiment. The best performance came from lower-rated, higher yielding issues in oil and gas, energy generation, real estate and autos. In the long-end, utilities and pipelines outperformed, while financial services, industrials and securitization underperformed.

Portfolio Activity

Exposure to non-viable contingent capital (NVCC) was reduced after significant outperformance (purchases were made at all-time wide yield spreads), and given our view that the technical and fundamental drivers behind the NVCC rally have largely played out. Exposures to provincial and senior bank debt were increased to take advantage of attractive relative value opportunities. Credit quality, yield curve and duration bias were maintained.

What Worked In The Quarter

The portfolio's corporate exposure was concentrated in shorter dated, higher yielding issues in top performing sectors: communications, NVCC and senior debt of non-systemically important domestic banks. Generally, short-term corporates spreads outperformed as the credit curve bull flattened.

What Did Not Work In The Quarter

Relative to the index, the portfolio was more conservatively structured with a shorter-duration and an overweight in the 5-year area of the yield curve in lieu of long bonds. For the quarter, government 2 and 5-year yields rose by 15 and 11 bps respectively, while 10 and 30-year yields fell by 6 and 21 bps respectively.

Outlook & Strategy

Washington finally passed a bill with the potential for significant economic impact: we expect the Trump tax plan, while diluted from its original draft, to generate some economic stimulus. The NAFTA negotiations are still very difficult to predict, and will likely impact Canadian exports (they are already impeding investment), but we are hopeful that any negative outcomes will be contained.

As the yield curve flattens, the risk/reward trade-off in the bond market would seem to shift further in favour of shorter-term bonds, unless of course, the economy legitimately slows in 2018 – not in our forecast. We have been positioned for higher yields and a steeper yield curve for some time and investor complacency with respect to real yields and inflation expectations has made this an underperforming position in 2017. We still expect to see higher long-term nominal yields as long-term real yields rise due to Fed balance sheet unwind and slower ECB QE, and inflation expectations increase due ongoing tightening of labour markets and consequent wage increases.

We continue to expect investors to be cautious with exposure to higher levered debt out the credit curve, particularly for those issues with limited secondary market depth. However, corporate spread levels, which currently represent about forty percent of all-in yields, still provide excellent relative value. The corporate allocation has good liquidity and is structured conservatively with minimal exposure to sectors or issuers that would be negatively impacted in the event of higher interest rates; and is well positioned to capitalize on relative value and yield enhancement opportunities.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

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