December 31, 2017

LORICA | INVESTMENT COUNSEL INC.

Short-Term Bond

Market Highlights

Short-term Canadian yields were 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. However, good economic data in December coupled with the upward movement of short-term Treasuries, ultimately pushed yields higher by quarter-end. One, two, three and five-year Canada yields were higher on the quarter by 14, 15, 14 and 11 bps respectively resulting in a fourth quarter return of 0.28% for the FTSE TMX Canadian Short-Term Bond Index. The short-term yield curve (1 to 5-year) was relatively stable during Q4 after having displayed more volatility during the first three quarters of the year – trading in about a 40 bps range.

The Canadian consumer has proved to be extremely resilient throughout the year, supported by low rates and a surprisingly robust jobs market, giving the Bank of Canada further opportunity to normalize rates. However, exports remain a concern for the Bank, 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.), and most importantly given the NAFTA negotiations which continue to hang in the balance.

Short-term US yields continued to move higher during Q4, adding further momentum to the move that began in the summer. Investors appear to finally be convinced that the Fed is genuinely intent on ratifying its guidance for rate increases – ultimately raising rates twice in the second half of the year. Although inflation expectations have only increased recently – the St. Louis Fed's 5-year, 5-year forward expectation rate had troughed for the year at 1.8%, and has risen to 2.1% by year-end – the Fed appears determined to continue with further increases in 2018.

Provincial and corporate yield spreads tightened by 7 and 10 bps respectively in the short-end of the yield curve during the quarter, representative of the broad-based risk-on sentiment. In the corporate sector, the best performance came from lower-rated, higher yielding issues in oil and gas, energy generation, real estate and autos.

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. On a duration weighted basis, exposure was increased to sectors that should be positively impacted by higher interest rates – senior bank debt, insurance and telecom. The credit quality of the portfolio was maintained, and the portfolio's duration was neutral relative to the index.

What Worked In The Quarter

The portfolio was overweight corporate and provincial credit which rallied. The portfolio's credit exposure was overweight shorter dated, higher yielding issues in top performing sectors: telco, media, NVCC and senior debt of non-systemically important domestic banks. The provincial holdings were concentrated in Ontario, Alberta and Manitoba issues which were top performers. The portfolio had no exposure to British Columbia and Quebec debt which underperformed.

What Did Not Work In The Quarter

Relative to the index, the portfolio was more conservatively structured with a bias for a steeper yield curve. For the quarter, the 1 to 5-year yield flattened by 3 bps.

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.

The Bank of Canada surprised investors in 2017 with little advanced warning of impending rate hikes, flattening the Canadian yield curve, as short-term yields adjusted to higher overnight rates. 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 was to legitimately slow in 2018 – not in our forecast. Given the short maturity distribution of the Short Term portfolio, its duration will naturally shorten quickly. In Q4, we lengthened the duration to neutral, given our belief that the BoC would be on hold for the remainder of the year, and sit on the sidelines until there was more clarity vis-à-vis NAFTA. Recent, strength of Canadian economic data (payrolls, retail sales, etc.), would suggest that the Bank is back in play – we will allow the duration of the portfolio to naturally shorten, given higher odds of a hike.

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, short-term corporate spread levels, which currently represent over thirty 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.

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