March 31, 2017

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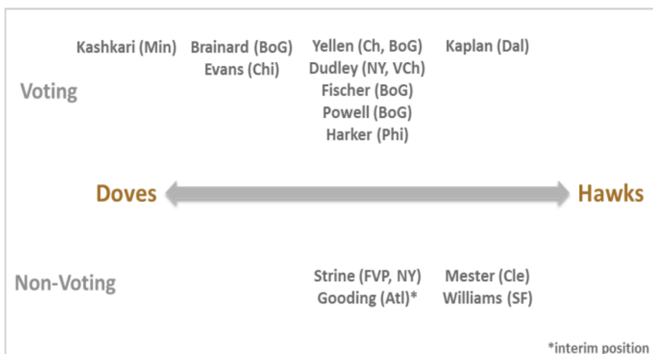
What We Think...

Bond Yields

With so much focus on the “Trump trade”, there is irony in the fact that the Fed is once again taking responsibility for moves in the bond market. It is no longer the assumption of benign monetary policy that has kept yields low and rallied risk assets, but rather that the credible message of tighter policy through higher rates and balance sheet-unwind that has raised yields. The Fed has gone out of its way to communicate that tighter policy is now necessary, while appearing less determined to hedge its bets, all the while continuing to emphasize its data dependency. (We note, that reminding investors of data dependency has become routine for the Fed, and as such, is more-or-less redundant.) Following the election, it was our contention that bond yields were no longer pricing-in the status quo of government economic policies, but some probability that there would be implementation of Trump’s platform. We did not believe that investors were pricing it 100% success, but more likely, closer to 50%. Although, we are approaching Trump’s first 100 days in office, and success on many policy fronts seems distant, we still believe some assumption of policy success is still warranted, although less than what was assumed in December. Nevertheless, monetary policy, not government policies, has regained the foothold as the main driver of government yield levels. In contrast, corporate yields spreads (along with valuations of other risk assets) appear more dependent upon the optimism surrounding the success of Trump’s economic stimulus policies.

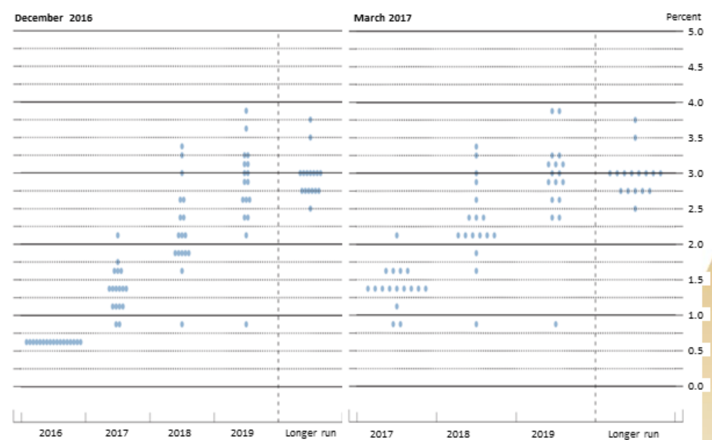
Figure 1: Doves & Hawks



Source: Lorica Investment Counsel Inc., March 2017.

We have updated our chart “Doves & Hawks” (Figure 1) which illustrates our understanding of the current policy views of the members of the FOMC (voting and non-voting). There has been a notable “hawkish” shift amongst committee members, which is evident from the many comments made by FOMC members during February and March, and changes to the “dot plot”, released after the March FOMC meeting (see Figure 2). We note the continued tightening in US labour markets – March’s unemployment rate has dropped to 4.5%, and the gradual uptick in inflation expectations – the Fed’s favourite 5-Year, 5-Year Forward Inflation Expectation Rate (T5YIFR) has risen from a low of 1.5% in February 2016 to the current level of 2.2%. However, we also note that the T5YIFR was much higher in 2014, when policy was on hold; so what has changed? We feel that “risk-on” behaviour in current markets is being fuelled less by Fed stimulus and more by economic and policy expectations, making the Fed less concerned about market vulnerability to rate increases. In our view, much of the Fed’s reluctance to raise rates over the last couple of years was due to its overarching concern with derailing capital markets – equities in particular; thus, limiting its increases to solitary annual moves, conveniently timed close to calendar year-end (this limited any damage of rate increases). Today, consumer sentiment is running high (Figure 3) which underscores the Fed’s window of opportunity for raising rates that we expect it to take advantage of in 2017 – likely for a total of 3-4 rate increases.

Figure 2: Federal Reserve Dot Plots



Source: Federal Reserve & Lorica Investment Counsel Inc., March 2017.

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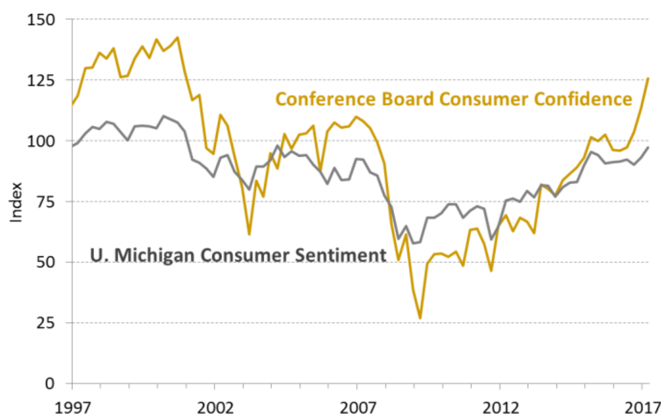
Figure 3: Consumer Confidence & Consumer Sentiment

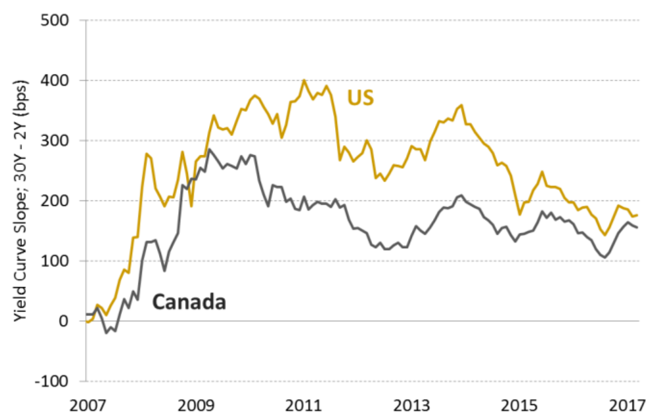


Notes: Quarter; 100 Levels: Conference Board Consumer Confidence – 1985; U. Michigan Consumer Sentiment - 1060
Source: Conference Board, University of Michigan Survey of Consumers & Lorica Investment Counsel Inc., March 2017.

The path forward for the Bank of Canada will likely be less eventful than for the Fed. Recent economic data has surprised to the upside, showing the economy in recovery. We expect real GDP gains to continue, given the stabilization of commodity prices; and with a relatively large output gap, inflation will remain well-contained. However, it is still too early to conclude that we are safely past the energy price declines of 2015, especially given the volatility of prices. Employment volatility and the dependence on the service economy for a substantial part of the recovery also pose risks for growth. It is also risky to assume that the contribution from manufacturing and trade will continue, despite the devaluation of the loonie; even the Bank has conceded that there are many unknowns driving these sectors.

There are other large uncertainties facing the BoC, principally, the path of infrastructure spending, impending NAFTA negotiations and US taxation policy changes. In the case of infrastructure, we are yet to see implementation of the government's platform. As for NAFTA, there is uncertainty at every turn, with the potential to damage consumer sentiment in the short-run and economic growth in the long-run. We expect the Bank of Canada to choose to remain on the sidelines until its picture becomes clearer, which will easily take us in to 2018. We don't expect the Bank to be too concerned with a widening gap in short term interest rates versus the US, as we think Poloz still believes a weak dollar is favourable to Canada's terms of trade.

Figure 4: US vs Canada Yield Curve Slope: 2-30 Years



Source: Bloomberg & Lorica Investment Counsel Inc., March 2017.

The slope of the 2-30's US yield curve (Figure 4) currently sits at 169 basis points, which is 30 bps shy of the lows since the credit crisis, experienced in August of last year. You may recall the last time the US Treasury curve flattened significantly was in 2004-6 when the Federal Reserve raised rates by 400 bps from 1% to 5%. Prior to the first increase in 2004, the 2-30's yield curve was much steeper than it is today, at over 350 basis points; granted we have already seen rate increases in the current cycle, but Fed Funds were at the same levels as where they are today. We attribute today's flatter yield curve to a combination of lower inflation expectations – a feature of the current cycle, and quantitative easing (QE). Until wage pressures start to show through in average hourly earnings, we do not expect inflation expectations to exert steepening pressure on the yield curve, despite expectations for a relatively modest trajectory for Fed Funds. However, unwinding of QE does have the potential to increase longer-term real yields, thus exerting steepening pressure on nominal yields. Although the Fed has not made a formal announcement on its balance sheet unwind strategy, they have indicated an eventual unwind through reduced reinvestment of maturities. Overall, we foresee a parallel shift of the Treasury yield curve alongside Fed rate increases.

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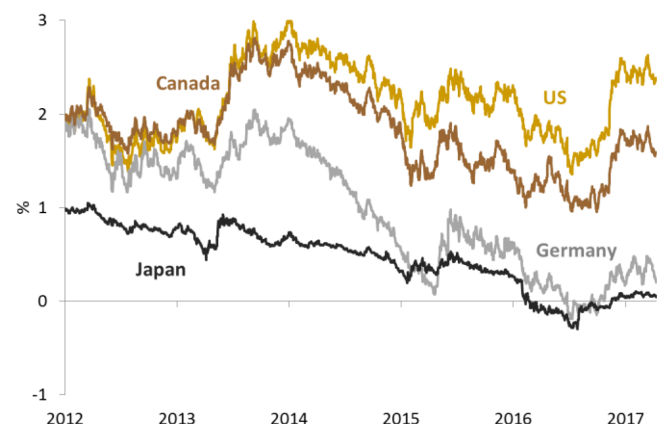
Changes to the shape of the Canadian yield curve are easier to predict, given that the rise of US mid and long-term yields will likely result in a similar, albeit muted, rise of Canadian mid and long-term yields; and, as we mentioned above, we do not expect any action from the Bank of Canada. We do acknowledge that there may be volatility in short-term yields, as investors respond to optimism over the Canadian economy. Nevertheless, it is reasonable to expect the Canadian yield curve to steepen as US yields move higher.

The Fed's hawkish stance has put it out of sync with other developed country central banks, highlighting the impact that growing policy differences might have on developed country bond markets (Figure 5) and currencies. We can think of many times since the credit crisis, where looser ECB policy precipitated falling European yields that in turn exerted downward pressure on US yields and upward pressure on the dollar. The ECB and BOJ QE policies have likely been the biggest influence on driving foreign investment into the US bond and currency markets in recent years. We believe the biggest difference in today's environment is the relative stability of current ECB and BoJ policies and the diminished expectations of extensions to their respective QE programs. However, given that both Draghi and Kuroda have demonstrated a readiness to implement greater stimulus at signs of economic retrenchment, it is still possible that we will see further QE activity flowing through into US and Canadian markets.

Figure 5: 10 Year Sovereigns & US Spreads



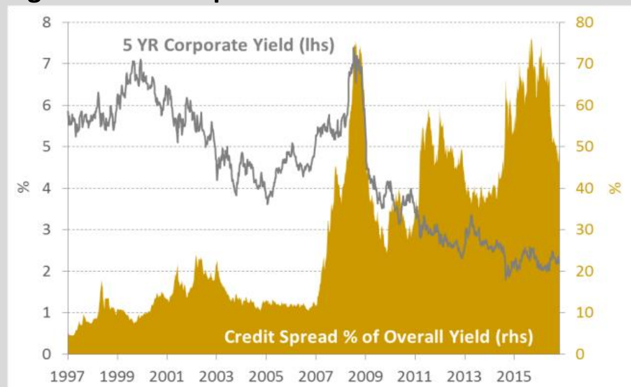
Source: Bloomberg & Lorica Investment Counsel Inc., March 2017.

Corporates

Year to date, global corporate bond markets have performed well as broadly favourable credit conditions for spread compression have remained intact. Canadian credit markets have been further buoyed by supply/demand imbalances and firmer commodity prices. While corporate spreads continue to provide good relative value, we see headwinds on the horizon as higher interest rates, eroding credit metrics and the increase in lower-rated debt issuance has made the domestic corporate market more sensitive to global event risk, particularly for higher levered debt with longer maturities.

From a relative value perspective, five-year corporate yield spreads at 106 bps are contributing 49% of the average five-year corporate yield to maturity (see Figure 6). While off from post-crisis highs, this level of contribution provides a degree of breakeven protection from rising bond yields and scope for further spread compression – investment grade corporate yield spreads typically demonstrate an inverse relationship with rising underlying government bond yields. We feel that in this cycle however, there is elevated risk that evolving supply/demand dynamics may adversely reduce this negative correlation relationship (particularly for high-yield credit). In this vein, investing in short and mid-term investment grade credit mitigates some of this risk, while providing attractive breakeven protection, incremental yield pick-up and roll down (of approximately 10 bps a year in spread).

Figure 6: Credit Spread Contribution



Source: Bank of Canada, BMO & Lorica Investment Counsel Inc., March 2017.

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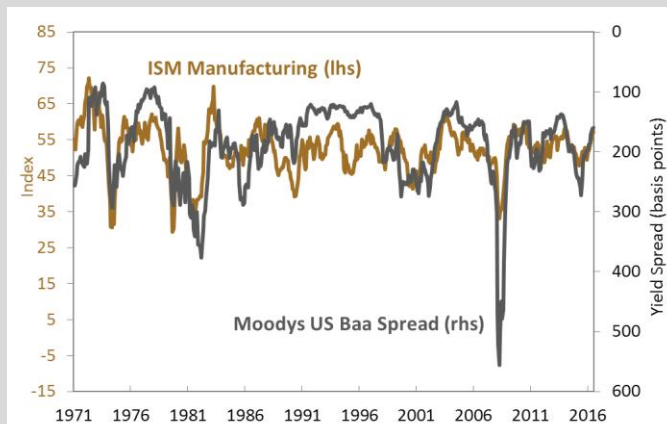
We feel that continued healthy macroeconomic activity will be supportive of investment grade spreads (see Figure 7). However, changes to regulatory, trade and taxation policies have the potential to disrupt the economy and result in unintended negative consequences. While regulatory and tax reform (including cash repatriation) would generally be positive for corporates as it would improve earnings and reduce issuance, an increase in tariffs and/or trade restrictions could be hugely negative for importers as well as for Canadian firms.

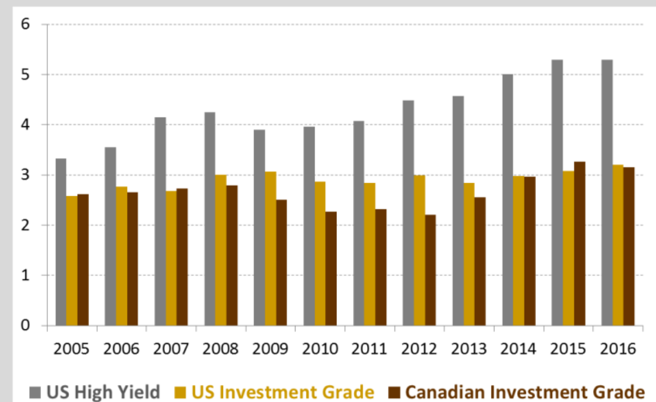
Figure 7: Corporate Spread vs. Economic Conditions



Source: Institute for Supply Management, Moody's & Lorica Investment Counsel Inc., March 2017.

Generally, the prospect for higher interest rates at this late stage in the credit cycle will put pressure on already deteriorating credit metrics (Figure 8). However, we feel that the impact is manageable for investment grade credit, given we are moving from a period of "ultra-low" interest rates to one that is just "low". From a profitability perspective, we also expect modest top-line driven earnings growth as consumers focus on debt-servicing. In reaction to a weaker growth profile however, we will see less credit-negative shareholder friendly initiatives and active re-leveraging events. In this "low" interest rate environment, we forecast a comparatively greater upside for sectors that benefit from yield curve bear steepening (e.g. banks and insurance), than downside risk for sectors negatively impacted by rising interest rates (e.g. real estate, unregulated utilities, pipelines and retail).

Figure 8: Nonfinancial Median Debt to EBITDA



Source: S&P Global Ratings & Lorica Investment Counsel Inc., March 2017.

As investor's have reached for yield, opportunistic borrowing has been led by BBB-rated sectors. While Canadian investment grade issuance in Q1 of $21.6 Billion was up only marginally from the five year Q1 average of $21.2 Billion, the proportional share of BBB-rated debt was up to 39% from a five year annual average of 26%. The same dynamics are occurring in the US where the pace of high yield issuance has doubled from the same period last year. Although there is limited refinancing risk in the near term – the majority of the $1.2 trillion in U.S. nonfinancial corporate high yield debt maturing in the next five years begins to come due in 2020. In addition, the large absolute number outstanding and reduced liquidity in the secondary market increases the contagion risk from defaulting issuers. Finally, corporate bond demand is being driven by a "perfect storm" – low interest rates, asset class inflows, and positive sentiment from a majority of investors whom remain overweight corporate credit. With higher interest rates on the horizon, these positive drivers of demand may be fleeting.

Thomas Gomes