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LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Although the Canadian economy outgrew the US economy last year, the more recent data is favouring US growth. However, it is the uncertainty of the future that is weighing far more heavily on Canadian bond investors, causing Canadian and US bond yields to diverge during Q1. US-Canada yield spreads widened by about 30 basis points across the curve during the quarter, driven by trade fears and out-of-sync monetary policies. The Fed is determined to make good on its projections to normalise rates by hiking ¼% per quarter; while the Bank of Canada is determined to sit on the sidelines, worried mostly about trade, but also about the indebted consumer and the housing market.

There is already reliable evidence that NAFTA negotiations are impacting Canada's economy – foreign direct investment was down by a disappointing 26% in 2017. Furthermore, non-energy exports have continued the (five-year) trend downwards, despite the recent weakness in the Canadian dollar. It is anyone's guess what will ultimately happen to global trade – the Trump administration appears determined to reduce the US's massive trade deficit, and no trading partner appears safe. The emerging trade battle with China could become a protracted trade war, with weaker economic growth a real possibility.

The Canadian bond market returned 0.1% in Q1 (FTSE TMX Canada Universe Bond Index) vastly outperforming the US bond market which returned -1.46% (Bloomberg Barclays US Aggregate Bond Index). Canadian yields were up a marginal 5-10 bps between 2 to 10-years, whereas 30-year yields were down by 4 bps. Treasury yields were up substantially across the curve: 2, 5, 10 and 30-years rose by 38, 36, 33 and 23 bps respectively. While the overall Treasury curve has tended to flatten following Fed moves, a lot of the flattening has been captured by the long-end. In Q1, the 2-10 Treasury curve flattened by 5 bps, while the 10-30's curve flattened by 10 bps. Despite Canadian yields remaining relatively stable, the long Canada curve flattened by a similar amount to the US – 9 bps during the quarter. Excess demand for long Treasury bonds – the ECB and BoJ are still in QE mode – continues to spill over into long Canadas.

The corporate bond market was volatile during Q1, echoing movement in the stock markets. Worries over trade policy and troubles in the tech space (notably Facebook and Tesla) were enough to shake investor confidence and correct equity valuations that have been kept aloft by overall positive economic data and supportive fiscal policies. The S&P 500 managed to give back all of January's 5.73% gains by the end of the quarter – finishing down by 0.76%. For the quarter, Canadian corporate bonds underperformed Canada's (0.28% versus 0.41% for the Corporate and Canada components of the Universe Index with spreads widening an average of 6 bps across the curve.

Portfolio Activity

Provincials spreads were pressured as a heavy supply calendar and unfavourable swap levels deterred foreign issuance in lieu of domestic issuance. With the backup in yields the opportunity was taken to increase exposure to provincial debt.

What Worked In The Quarter

The portfolio was underweight provincials and corporates on a duration weighted basis relative to the benchmark. Provincial and corporate spreads widened by an average of 8 and 6 bps respectively over the quarter.

What Did Not Work In The Quarter

With our forecast of higher rates and a steeper yield curve on the horizon, the portfolio was more conservatively structured relative to the benchmark with a shorter-duration and an overweight in the short and mid-term area of the yield curve in lieu of long bonds. The 2-30's yield curve flattened by 9 bps over Q1.

Outlook & Strategy

As we had anticipated, the mood of Poloz and the Bank of Canada has become cautious. The spread between policy rates and short-term yields has widened and should continue to do so until US trade policy engenders more certainty and confidence. We are still optimistic that there will be a resolution to NAFTA negotiations, agreeable to Canada. However, in the meantime investors will remain worried about the long-term impact of trade policy on the Canadian economy (evidence by decreased correlation of 10-year and long Canada and Treasury yields). Assuming a satisfactory "NAFTA" outcome, we expect narrowing of longer-term US-Canada spreads.

The portfolio has been positioned for higher yields, which has meant a significantly shorter duration versus the benchmark and many peers. It also has meant that the portfolio has been biased towards steeper yield curves. In Q1, 2, 5 and 10-year yields rose, but long bond yields fell causing the curve to flatten. We continue to expect the portfolio to perform well on a relative basis, as we expect the yield curve to rise further and steepen.

Our portfolios are at their maximum corporate weights, with as many better quality short-term maturities as possible. We are also overweight provincial credit (where applicable), albeit generally with longer maturities. The credit overweight both compensates for the yield disadvantage resulting from the portfolios overall shorter duration and provides additional protection against rising yields.

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