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LORICA | INVESTMENT COUNSEL INC.

Short-Term Bond

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 between 29 to 33 basis points across the short-term 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 short-term Canadian bond market returned 0.22% in Q1 (FTSE TMX Canada Short-Term Bond Index) vastly outperforming the similar US bond market which returned -0.51% (combination of Bloomberg Barclays US Aggregate 1-3 and 3-5 Year Bond Indexes). Canadian yields were up only about 10 bps between one-to-five-years, while Treasury yields were up substantially – 2, 3, and 5-years rose by 38, 41 and 36 bps respectively. While the overall Treasury curve has tended to flatten following Fed moves, only 2 bps came from the one-to-five-year area in Q1; the short-term Canada curve did not flatten. Notably, most of the flattening in US and Canadian yield curves has taken place in the long end where demand for long bonds – the ECB and BoJ are still in QE mode – continues.

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, short Canadian corporate bonds performed about on par with short Canada's: 0.25% versus 0.26% (Corporate and Canada components of the Universe Index), despite spreads widening an average of 7 bps the short end.

Portfolio Activity

In anticipation of a steeper yield curve, exposure to 5-year provincial debt was reduced with a commensurate increase in shorter-dated corporate and provincial debt which had lagged.

What Worked In The Quarter

With our forecast of higher rates on the horizon, the portfolio was more conservatively structured relative to the benchmark with a shorter-duration. For the quarter, 2, 3, 4, and 5-year government bond yields rose by 5, 11, 11 and 7 bps respectively.

What Did Not Work In The Quarter

The portfolio was overweight provincials and corporates on a duration weighted basis relative to the benchmark. Short-term provincial and corporate spreads widened by an average of 3 and 7 bps respectively over the quarter.

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 mid and long Canada and Treasury yields). Assuming a satisfactory "NAFTA" outcome, we expect narrowing mid-term US-Canada spreads.

The portfolio has been positioned for higher yields, which has meant a shorter duration versus the benchmark. 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 overall 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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