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LORICA | INVESTMENT COUNSEL INC.

Short-Term Bond

Market Highlights

We don't typically feel sorry for central bankers – they are deliberately aloof, and the challenges of the job comes at the price of being "rock stars" – but we are sympathetic to Governor Poloz as he tries to navigate the minefield that President Trump and his trade advisors are laying. It is 42 months since the Bank first implemented its "insurance rate decreases" and Canadian economic growth has averaged 2.5% yoy. The Bank has since, raised rates by 75 bps, but the overnight rate sits at 1.25%, well below the average of the last 30 years (4%), well below the consensus neutral level (3%), and well below current Fed Funds (2%). The Bank should be able to raise rates and establish more of a cushion ahead a future downturn, but the uncertainty related to trade, not to mention, the damage already done, is forcing the Governor to equivocate. He has eschewed forward guidance at the expense of misleading investors which has resulted in significant volatility in the short-end of the Canadian yield curve.

The world is increasingly on tenterhooks, waiting for the next trade moves by the Trump administration and their foes; however, you wish to call it, we see it as the early stages of a trade war. US economic growth has been strong – somewhere near 3.4% for Q2 (Bloomberg) – providing cover for the administrations foray into trade conflicts. Let's hope for Trump, and us all, that the US economy does not decide to dive south. But the Fed is determined to normalise interest rates and its balance sheets, leaving us only somewhere in the middle of their tightening cycle. The stock market is already getting a little nervous from the combination of higher rates and tariffs, and we have seen a flat-lining since mid-January.

The short term Canadian bond market returned 0.31% for the quarter and 0.53% year-to-date according to the FTSE Canada Short Term Bond Index, significantly outperforming the similar term US bond market at 0.17% for the quarter and -0.34% year-to-date (USD terms) according to the Bloomberg Barclays US Aggregate 1-3 & 3-5 Year Bond Indices (market cap weighted). Performance across sectors was relatively consistent, with Canada's, provincials and corporates returning 0.27%, 0.37% and 0.33% respectively for the quarters, as the additional yield pickup for corporates and provincials was mostly offset by yield spread widening.

Portfolio Activity

On the back of supply pressure, the opportunity was taken to increase corporate exposure to pipelines, retail and deposit notes. The portfolio's duration, yield curve and high credit quality bias were maintained.

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, 1, 3 and 5-year government bond yields rose by 8, 9 and 10bps respectively.

The portfolio was overweight provincials with a concentration in Alberta and Manitoba debt which were top performers.

What Did Not Work In The Quarter

The shorter duration of the portfolio results in a lower running yield however this has more than been offset with an overweight exposure in high grade credit which outperformed the benchmark. The portfolio had no exposure to NVCC bank debt which underperformed.

Outlook

We expect the Federal Reserve Board to continue to raise interest rates at the pace of once per quarter for the remainder of the year. In contrast to the Fed and market expectations (Overnight Indexed Swaps suggests a hike in July), we think the Bank of Canada will be forced to play it safe and wait for more clarity on Canada-US trade, before raising rates. The widening spread of overnight rates will contribute to a wider and steeper US-Canada spread curve and a weaker Canadian dollar.

While we have consistently qualified our outlook for the Bank of Canada with the outcome to the NAFTA negotiations, we have generally preferred to be optimistic as to the eventual ramifications for Canada. However, realistically, we are already immersed in negative outcomes with tariffs enacted and a US government clearly determined to get favourable outcomes for the US. Although the current actions represent a relatively small impact on near-term growth, the broader uncertainty is already impacting longer-term growth by hurting investment in Canada.

Our portfolios have been positioned for higher yields, which has meant that we have had significantly shorter duration versus the benchmarks and many of our peers. It also has meant that the portfolios have been biased towards steeper yield curves. However, Canadian long-term yields have been resistant to rising, but we still expect higher inflation expectations to eventually translate into greater term premiums and a steeper yield curve.

Our portfolios are at their maximum corporate weights (by market value), with as many better quality short-term maturities as possible. We are also overweight provincial credit, albeit generally with shorter 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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