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LORICA | INVESTMENT COUNSEL INC.

Short-Term Bond

Market Highlights

5-year Treasury and Canada yields both finished very close to their peak for the year at 2.96% and 2.34% respectively. As of writing, the Canada 5-year yield is at 2.44% following the announcement of the United States–Mexico–Canada Agreement (USMCA) on Sunday, September 30th and strong US data. Once NAFTA negotiations began in earnest in August of last year, it became apparent that a new deal was not going to be that easily achieved and to some, possibly not achieved at all. Markets assessed the risks by widening US-Canada yield spreads, such that 5-year Treasuries to Canadas widened from 33 bps at the beginning of the year to 62 bps to the end of September and depreciating the Canadian dollar by 2.1 cents over the year. Following Sunday's announcement, the 5-year spread initially narrowed, but subsequently widened as US yields have risen abruptly. The $CAD has risen by 0.45 cents. It will be interesting to see just how much uncertainty will dissipate from the markets and ultimately the real economy, now that an updated trade agreement looks likely (Congress must still approve the deal).

Throughout the third quarter Canadian bond investors were faced with conflicting forces of "better-than-expected" economic data and the possibility of no trade deal with the US. They've also had to anticipate the Bank of Canada's policy response amidst generally strong economic data, tightening labour markets and "hawkish" monetary policy from the Fed. Investors, sensing that the Bank was leaning to more rate increases while still discounting no deal, further flattened the Canadian yield curve: 2-5's Government of Canada and Treasury yield curves were 13 bps and 11 bps at quarter-end. Some of the pressure on the Canadian bond market has emanated from foreign demand, given low European and Japanese yields which have spiked the demand for higher yielding high quality debt elsewhere.

For the quarter, the short term (1-5 year) Canadian bond market returned 0.01% according to the FTSE Canada Short Term Bond Index compared to 0.25% for the short-term Bloomberg Barclays US Aggregate Bond Index (cap-weighted 1-3 Year and 3-5 Year bond indices). The best performing part of the Canadian market was short corporate bonds which returned 0.21%, versus -0.14% and -0.01% for short Canada's and provincials respectively, and -1.84% for long corporates (all according to the Universe Index). The worst performing part of the market was long Canadas which returned -2.83%, followed by long provincials at -2.55% (also according to the Universe Index). Only short corporate bonds provided enough yield break-even protection to generate positive returns for the quarter.

Portfolio Activity

Exposure to senior bank debt of non-systemically important domestic banks was increased via a reduction in media debt which had significantly outperformed. The portfolio's duration, yield curve, sector and high credit quality bias were maintained.

What Worked In The Quarter

The portfolio was more conservatively structured relative to the benchmark with a shorter-duration, with an overweight in the 1-3-year area of the yield curve in lieu of longer bonds. For the quarter, 1, 3, and 5-year government bond yields rose by 23, 25 and 24bps respectively. The portfolio's corporate exposure was overweight shorter dated, higher yielding issues in top performing sectors: media, banks (senior deposit notes) and insurance. On a duration weighted basis, the portfolio's corporate spreads tightened by 6bps. The portfolio continued to be overweight provincials which were top performers: Alberta, Manitoba and New Brunswick; and had no exposure to Quebec debt, which lagged.

What Did Not Work In The Quarter

The portfolio is overweight short auto debt relative to the index, which was dragged down by Canadian/US trade tariff fears.

Outlook & Strategy

With a US-Canada trade agreement basically "in the bag", we can get back to basing our outlook more on analysis than a game of roulette. The Trump administration will likely ensure that the markets continue to endure volatility relating to the presidency, trade, etc. Barring the unpredictable however, we expect the US economy to continue to deliver reasonable growth and tighter labour markets – the Fed will respond with at least three rate hikes over the next 12 months, consistent with market expectations. The Bank of Canada will also find itself in a better position to implement policy, and should follow the Fed's lead, albeit likely with one less hike over the same period.

From a credit perspective, the portfolio possesses good liquidity and is structured conservatively with minimal exposure to sectors or issuers that will be negatively impacted by higher interest rates; and is well positioned to capitalize on relative value and yield enhancement opportunities.

There are distinct risks to both the US and Canadian economic outlooks. In the US, a let-down following the large fiscal stimulus is a major concern, as is the evolving US-China trade war. In Canada, the reliance on the leveraged consumer and an unproven rebound of foreign investment and trade give us some concern.

While higher policy rates will have an impact on the portfolio, they are not the only factor; the rise in mid -term yields will likely have a greater impact. Over the last year, the US and Canadian yield curves have flattened extensively due to higher policy rates from the Fed and BoC, and relatively little change to long-term inflation expectations. We think the greatest risk to returns in the Canadian bond market will be a re-pricing of the mid and long-ends from both real yields and inflation. The underweight in mid-term bonds should benefit performance.

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