December 31, 2018

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The month of December was a volatile month in what has been a volatile quarter in a volatile year for the bond market. Five and ten-year Government of Canada yields finished the year roughly where they started – around 1.9% and 2%, after having gone as high as 2.5% and 2.6%, respectively, in October. Short-term yields and consequently the slope of the yield curve have been more directional over the course of the year, with 2-year yields having risen from 1.6% to about 1.9% (although as high as 2.35%), and the 2-10's slope having flattened from 36 to 10 bps. Finally, credit spreads were also directional, widening by 43 bps on average in 2018 (according to the FTSE Canada Bond indices).

The Canadian 2-10's yield curve is flirting with inversion for the first time since 2007, when the Bank of Canada was raising interest rates pre-Credit Crisis. In fact, the move to inversion is more pronounced in Canada than in the US, where the similar curve is 21 bps – also levels not seen since 2007. The move to inversion in Canada has been driven by a combination of technical factors influencing the supply/demand relationship, particularly in the long-end, and fundamental factors that are weighing heavily on the Canadian economic outlook.

In December, the US stock market almost entered "bear market" territory (a 20% correction), which has contributed to anxiety amongst investors and politicians alike. President Trump's unprecedented but unsurprising attack on not just the Fed, but Chairman Powell personally, has further unnerved markets, especially given the implications for Fed credibility going forward. However, U.S. economic data, while weaker, still suggests reasonable growth is ahead. The labour markets in particular remain healthy and are showing signs of confidence building wage growth.

Unfortunately, the list of domestic factors creating market volatility and threatening the US economy are significant, including higher rates, falling home sales, tight labour markets, slowing loan growth, aging tax cuts, the government shutdown, Mueller's investigation and a divided congress (with a prevalence of political and thus largely unpredictable factors.) In addition, the US-China trade war and corresponding slowdown in China's growth pose a material risk to the US (and Canadian) economies. (China's outlook is not easily anticipated given its history of propping up its economy through infrastructure investment and its current high level of government and private indebtedness.) The Canadian economy is also facing even weaker Western Canadian Select crude prices, more heavily indebted Canadian households, slowing housing markets in what have traditionally been the strongholds of Canadian housing growth of Vancouver and Toronto, and ongoing antagonism from the US on trade.

The Fed has continued its balance sheet reduction (quantitative tightening) at a pace of $50 Billion per month and interest rate increases at roughly 25 bps per quarter. Some commentators suggest that this is the major factor behind market and economic jitters. We won't dismiss this explanation readily, recalling that over the last ten or so years, the market has relied on easy monetary policy to encourage risk taking. Each time the market became nervous about taking such risk in recognition of the prospects of tighter monetary policy, the Fed backed off. Powell's recent comments pertaining to the flexibility of monetary policy indicate such accommodation from the Fed may once again be on offer.

Portfolio Activity

General risk aversion pressured credit in Q4. With the portfolio underweight credit relative to the index on a duration-weighted basis, we took the opportunity to increase exposure to credit via highly rated insurance and bank debt close to year-end. The portfolio's duration, yield curve, sector and high credit quality bias were maintained.

What Worked In The Quarter

The portfolio had no exposure to long-term corporate and provincial credit as long-term spreads widened by 31 and 23 bps respectively, and credit curves steepened. Credit exposure was concentrated in top performing higher-rated short-term senior bank, insurance, and Quebec and Ontario bonds. The portfolio had no exposure to higher-beta lower-rated retail, auto, media, subordinated bank, and oil and gas issues, which lagged.

What Did Not Work In The Quarter

In anticipation of yield curve steepening, the portfolio was more conservatively structured with a shorter duration relative to the benchmark and overweight's in the short and mid-term areas of the yield curve in lieu of long-bonds. For the quarter 2, 5, 10 and 30-year yields fell by 37, 45, 46, and 23 bps respectively however the 2 to 30-year yield curve steepened by 14 bps.

Outlook & Strategy

We still expect the US economy to deliver reasonable growth, tighter labour markets and higher wages. We expect the Federal Reserve to respond with two more rate hikes over the next twelve months, consistent with its guidance, but besting market expectations of less than one. We expect the Bank of Canada to follow the Fed's lead, but lag by a hike over the same period. Real yields should continue to expand across the yield curve, resulting in higher yields. Higher wages will eventually result in higher medium to long-term inflation expectations, ultimately placing some steepening pressure on the curve. Global sovereign flows remain a wildcard factor, affecting longer term US and Canadian yields.

There are risks to both the US and Canadian economic outlooks which have been exacerbated by volatile capital markets. We are of the belief that the biggest driver behind Fed (and BoC) policy, has been the effort to normalise rates across the yield curve, not the threat of higher inflation. We believe the Fed has missed past opportunities for normalization and does not wish to do so again. That being said, should the prognosis for the economy deteriorate, we would expect the Fed to quickly pull away from the current trajectory of its policy guidance.

Growth of both the high-yield debt market and the proportion of long-term debt outstanding, has increased the risk of the domestic corporate bond market, making it more sensitive to higher interest rates and global event risks. Conversely, highly rated, liquid, short and mid-term corporate bonds are attractive on both an absolute and relative value basis. We continue to maintain a defensive posture in the portfolio, with shorter duration, no long-end exposure, and an overweight in shorter duration, liquid, high quality corporate bonds. In addition, we are well positioned to capitalize on relative value and yield enhancement opportunities.

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