December 31, 2018

LORICA | INVESTMENT COUNSEL INC.

Short-Term Bond

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-year Government of Canada yields finished the year roughly where they started – around 1.9%, after having gone as high as 2.5% in October. Short-term yields and consequently the slope of the of the short-term yield curve have been more directional over the course of the year, with 2-year yields having risen from 1.68% to about 1.86% (although as high as 2.35%), and the 2-5's slope having flattened from 18 to 2 bps. Finally, short-term credit spreads were also directional, widening by 38 bps in 2018 (according to the FTSE Canada Short Term Bond Index).

Both the US and the Canada 2-5's yield curves are flirting with inversion for the first time since 2007, when the central banks were raising interest rates pre-Credit Crisis. The move to inversion in Canada has been driven by a combination of technical factors influencing the supply/demand relationship 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 subordinated bank debt. With the increase in relative value and the portfolio having no exposure to subordinated bank debt, we took the opportunity to increase exposure by adding bank debt callable in less than two years, at year-end. The portfolio's duration, yield curve, sector and high credit quality bias were maintained.

What Worked In The Quarter

The portfolio's corporate and provincial exposures were overweight two and three-year bonds and underweight five-year bonds, which benefitted the portfolio as the credit curve steepened. As a result, the impact of spread widening of the portfolio's corporate and provincial holdings were less than that of the index.

What Did Not Work In The Quarter

In anticipation of yield curve steepening, the portfolio was more conservatively structured with a shorter duration and an overweight in two and three-year bonds in lieu of five-year bonds. For the quarter 2, 3, 4 and 5-year yields fell by 37, 39, 41 sand 45 bps respectively. The portfolio was overweight credit as corporate and provincial spreads widened by 34 and 13 bps respectively, although the exposure was partially offset by favourable credit composition and breakevens.

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 exposure to debt of five years-to-maturity or longer, and a preference for liquid, high quality corporate bonds. In addition, we are well positioned to capitalize on relative value and yield enhancement opportunities.

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