LORICA | INVESTMENT COUNSEL INC.

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Focused Fixed Income

Market Highlights

North American bond yields tumbled an average of 28 bps in both Canada and the US in March after being directionless for much of the first quarter. Investors forced the yield curve flatter: inverting 2 to 5-years (-3 bps), thus paving the way for the Fed to effectively remove any expectations for a rate hike in 2019. On the quarter, Canada and US 2, 5, 10 and 30-year yields fell by 31, 36, 34, 28 and 23, 28, 28, 20 bps respectively. The Fed's dot plot for the target rate for Fed Funds (updated March 20th) show the majority of FOMC participants expecting no move in 2019 (none are predicting an ease), while Fed fund futures are now pricing in a 60% probability of an ease by the December meeting.

In the second half of last year, the Fed began to emphasize data dependency, so it was no surprise when the Fed began to walk-back tighter policy guidance in Q1. The weaker US economy became very evident with both consumer and business indicators sending troubling signals at the turn of the year. There were also a host of political factors to consider, including: the US "wall-debt limit" showdown, US-China et. al. trade battles, receding tax-cut dividends and general political uncertainty (the Mueller investigation). Of course, there were the rate increases which were apparent in the weaker interest sensitive parts of the economy, notably housing. Finally, the global slowdown gained momentum, significantly impacted by the decline in global trade.

In Canada, the situation was and is more troubling – fourth quarter GDP (released at on March 1st) was a tiny 0.4% QoQ SAAR (compared with the US at 2.2% QoQ SAAR.). And though, the median consensus forecast (Bloomberg) for real GDP growth in 2019 is much higher at 1.5% (note: the consensus for Q4 was 1.2%), the economic backdrop has not improved measurably. Some economic indicators have improved: energy prices are higher and employment growth is still strong; but others have not: the housing market is clearly feeling the combined effect of higher rates, excessive consumer borrowing and revised mortgage and foreign ownership rules, and the trade deficit is yet to rebound. Notably, the Bank of Canada is clearly not ready to signal a major shift in policy – in its March interest rate announcement it simply suggested that there is "increased uncertainty about the timing of future rate increases".

Portfolio Activity

We increased the overall duration of the portfolio in late February via the purchase of twenty-year provincials, given our forecast (at the time) of a greater likelihood of bull flattening of the yield curve. We added provincials with reduced supply pressures, including Alberta, Ontario and Manitoba.

What Worked In The Quarter

The concentration of short and mid-term corporates was beneficial given credit curve steepening. Credit exposure was concentrated in top performing, higher-rated short-term senior bank, insurance, telecom and mid to long-term Alberta, Manitoba, Quebec and Ontario bonds. The portfolio had no exposure to federal, infrastructure, securitization, and energy generation issues, which lagged.

What Did Not Work In The Quarter

Although, the portfolio benefitted from the duration increase ahead of the yield curve decline in March, the portfolio was still conservatively structured relative to the benchmark. We note that the overall duration was 6.2 years (versus 7.7 for the benchmark) at the end of the quarter – still long in an absolute sense.

Outlook & Strategy

We expect the US economy to deliver reasonable growth with tighter labour markets and higher wages throughout 2019. However, the challenging trade environment and consequent impact on global growth will have a slowing impact on US growth. Canadian growth will be further impacted by a soft housing market and weak energy prices. 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 past Fed and, to a lesser degree, BoC policy, has been the effort to normalise rates across the yield curve, not the threat of higher inflation. Although the effort to normalise rates would appear to have stopped short of the Fed's original goal, the Fed's primary concern is and was always to maintain satisfactory economic growth. Consequently, given the prognosis for the economy has deteriorated from a year ago, we are not surprised that the Fed has moved to more accommodative policy by halting rate increases and tapering its balance sheet unwind. That being said, we expect the Fed to remain data dependent and responsive to changes to the economic and political environment. We still think it possible that the Federal Reserve will deliver one rate hike later this year but expect them to move with great caution. The Bank of Canada is grappling with serious structural issues including consumer debt, energy market dislocation and trade impairment which will impede any further move to normalise rates. We don't expect the Bank of Canada to do anything.

Although real yields should eventually expand across US and Canadian yield curves, falling global sovereign yields and resulting foreign purchases of North American bonds will remain a significant factor, depressing real yields. Finally, we believe that tight labour markets will eventually push inflation expectations higher, but given recent experience, are hesitant to predict the timing of this move.

In terms of credit markets, growth of both the proportion of long-term credit outstanding and the high-yield debt market have 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 credit are attractive on both an absolute and relative value basis. We continue to maintain a relatively defensive credit positioning in the portfolio, with an overweight in shorter duration, liquid, high quality corporate bonds, and exposure to longer term provincials. We are well positioned to capitalize on relative value and yield enhancement opportunities.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com