September 30, 2019

LORICA | INVESTMENT COUNSEL INC.

Short-Term Bond

Market Highlights

Bond yields across the globe were in decline during Q3 as economic growth slowed and central banks responded with easier monetary policy. US bond yields fell across the curve with 10 and 30-year yields falling more precipitously (33 and 41 bps respectively) than 2 and 5-year yields (13 and 21 bps respectively). Treasury yields hit their lowest points in the quarter during August, when yields across the curve fell by around 50 bps from their peak-July levels as investors priced-in additional interest rate cuts from the Fed. By the end of the quarter, the US 2-5's yield curve had flattened by 9 bps as Fed Chair Powell "walked back" easing expectations, while longer term yields continued to reflect low global yields and entrenched trade concerns.

Canadian bond yields were somewhat of an anomaly with 2-year yields rising by 10 bps and 5-year yields remaining unchanged, while 10 and 30-year Government of Canada yields followed the lead of Treasuries, but with far more modest declines of 10 and 15 bps, respectively. Like the Treasury curve, the Canada curve flattened by 26 bps, but is inverted from all the way from 2's to 30's versus a slope of +48 bps for the Treasury curve, reflecting the demand for longer term Canadas and little conviction on the part of investors that the Bank of Canada is interested in an imminent lowering of rates.

Higher energy prices and resiliency of the housing market – supported by lower rates – has sustained the Canadian economy thus far in 2019. Canadian growth to the end of Q3 is projected to be 1.9% annualized (using Bloomberg Q3 forecasts) on the back of surprisingly strong Q2 growth of 3.7% (SAAR). However, forecasts for calendar 2019 & 20 are 1.5% and 1.6% respectively, suggesting slowing in Q4 and into next year which is perhaps not being fully reflected by the BoC.

Corporate yield spreads resumed their tightening in September after widening abruptly in August in response to growth fears and central bank uncertainty. Short-term spreads were in about 1 bp for the quarter but have narrowed by 12 bps for the year. Given the return to a low yield environment, investors have shown a desire to pick-up yield, which was evident with the outperformance of higher yielding credits and the resumption of "risk-on" behavior in September.

Portfolio Activity

Bank debt was purchased to take advantage of steepening of the zero-to-one-year bank credit curve. The portfolio's duration, yield curve, industry and credit quality biases were maintained.

What Worked In The Quarter

The portfolio had a shorter duration as short-term yields rose. The portfolio was overweight provincial and corporate bonds relative to the benchmark as short-term provincial spreads tightened by 2 bps while short-term corporate spreads widened by 7 bps. In addition, the widening of the portfolio's corporate yield spreads was less than 2 bps, which was more than offset by the incremental yield pick-up.

What Did Not Work In The Quarter

The portfolio was more conservatively structured with steepening bias relative to the benchmark. The two-to-five-year curve bear steepened (longer yields rising) by 10 bps.

Outlook & Strategy

We still expect the US economy to deliver reasonable growth in 2019. However, the deteriorating and unpredictable trade environment – we are not hopeful that there will be substantial progress – and consequent impact on global growth will likely necessitate the Federal Reserve's continued involvement. We expect the Fed to deliver another rate cut this year or early next – their "body language" suggest they are prepared to act. Canadian growth is vulnerable to weaker exports and consumer fatigue, and with the Fed's activity, could combine to force the BoC also into lowering rates.

Long-term real yields should eventually expand, resulting in a steeper overall yield curve. However, negative Japanese and European sovereign yields and resulting foreign flows into North American bond markets will remain a significant factor, depressing both long-term US and Canadian real yields. Finally, we believe that tight labour markets should eventually push inflation expectations higher, but given recent experience, are hesitant to predict the timing of this move.

We believe supportive monetary policy and durable credit metrics have reduced the risk of a disorderly selloff for domestic investment-grade bonds; however, the risks for speculative credit classes remain elevated. The portfolio possesses good liquidity and is structured conservatively with a significant underweight in BBB-rated debt and is well positioned to capitalize on relative value and yield enhancement opportunities.

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