LORICA
INVESTMENT COUNSEL INC.

Short-Term Bond

December 2019

Market Highlights

Yields rose across the Canadian yield curve during the fourth quarter as investors responded optimistically to a host of factors suggesting that the Canadian economy is not in imminent danger and that the Bank of Canada is intent on remaining supportive. Perhaps more noteworthy in Q3 was the steepening of the yield curve – albeit still inverted – from the most negative levels since the credit crisis. Better-than-expected economic data, optimism surrounding the US-China trade war (again), an agreed revision to the USMCA, "hands-off" by the Fed and the BoC, and positive risk-on sentiment all contributed to higher yields, especially in the mid-term area of the yield curve: 1, 2, 3, 4 and 5-year yields rose by 2, 12, 17, 25 and 29 basis points respectively.

Despite the rise of short-term Canadian yields during the quarter, the Short-term Overall Index returned 0.14% with short-term Canadian corporate bonds dominant, returning 0.52% versus -0.09% for Canada's and 0.05% for provincials (FTSE Canada Short Term Overall Bond Index). With the Fed indicating no urgency to adjust policy, capital markets assumed a risk-on stance benefitting stocks and corporate bonds. High yield bonds, which had appeared vulnerable during the past summer, experiencing enormous yield spread volatility, rebounded in Q4 – US high yield spreads (Bloomberg Barclays US Corporate High Yield Index OAS) narrowed by over 100 bps from their Q3 highs by year-end.

Although uncertainties which have hung over the bond market for much of the year, persisted in Q4, a combination of naivete, skepticism and perhaps fatigue enabled investors to largely ignore nagging concerns and drive yields up and yield spreads down by year-end. However, these underlying uncertainties, which have not disappeared and will remain a risk to the Canadian economy, include trade vulnerability, excessive household debt, weak capital investment, unsteady wage growth, a beleaguered oil & gas sector, and a recalcitrant China.

Portfolio Activity

With the backup in yields and our forecast for short-term yields to remain anchored, the duration of the portfolio was increased to neutral versus the benchmark. The portfolio also increased exposure to provincial and senior bank debt via a reduction in pension and subordinated bank debt.

What Worked In The Quarter

The portfolio was structured with a shorter duration relative to benchmark with a concentration in credit maturing within two years in lieu of five-year debt. The portfolio's overweight in provincial and corporate credit (market and duration weighted basis) benefitted from industry and issuer composition as credit spread narrowing (7 and 17 bps respectively was greater than that of the respective benchmark sector spread narrowing).

What Did Not Work In The Quarter

There were no significant negative factors impacting the relative performance of the portfolio over the quarter.

Outlook & Strategy

We expect the US and Canadian economies to deliver reasonable growth in 2020. Low unemployment rates and ample wage growth will continue to fuel domestic consumption and ultimately, domestic growth. The hostile and unpredictable trade environment – we are skeptical that there will be substantial progress between the US and China – and consequent impact on global growth will likely necessitate continued accommodative monetary policy from central banks. We think it possible that the Fed and Bank of Canada each deliver another rate cut over the course of the year – but both will be reluctant to make a move.

We have positioned the portfolio for a steeper yield curve, but with no imminent change to policy rates. We believe that real yields should eventually expand; however, negative Japanese and European sovereign yields and resulting foreign flows into North American bond markets will remain a significant factor, depressing both US and Canadian real yields. Finally, we believe that tight labour markets should eventually push inflation expectations higher, but recognize that significant structural factors may continue to delay such a move.

The environment should remain favorable for Canadian investment-grade bonds given supportive monetary policy, healthy debt servicing metrics, benign refinancing risks and a well-capitalized banking sector. We feel that risks for speculative credit classes remain elevated given that credit profiles are significantly weaker than what was seen in comparable past downturns and given the market's fleeting risk tolerance and limited capacity to absorb riskier debt outflows during times of market stress. The corporate exposure possesses good liquidity, is structured conservatively, and is well positioned to capitalize on relative value and yield enhancement opportunities.

The political and geo-political arenas will inevitably be something to watch closely in 2020. In Canada, the government will be challenged with so many uncertainties while governing as a minority. In the US, there is an impending senate impeachment trial, an election, trade confrontations (especially with China) and mounting conflict with Iran and its allies. In Europe, there is growing nationalism and, of course, Brexit. Finally, in Asia, China's ambitions to be the dominant power, will continue to test governments everywhere on how they should deal with China on every level.