March 31, 2019

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What We Think…

In February we lengthened the duration of our portfolios consistent with our reduced expectations for higher bond yields. We had long maintained that bond yields would continue to rise, particularly in the longer end, where yields had been held down by a stubbornly flat yield curve. Economic growth this expansion has been sub-par, but we have been confident that it would continue despite tighter monetary policy. However, growing nationalist sentiments, especially coming from the US has been harmful to global trade and in turn, global growth. Consequently, growth has slowed, inflation expectations have declined, and central banks have been forced to reconsider their monetary policies. The drive to raise interest rates and bring yields to more normalised levels has had to stop abruptly – the Fed has reined in its ¼ per quarter tightening policy and the ECB has again pushed tighter policy further into the future. The Bank of Canada, which had already stepped to the sidelines, has reiterated its caution. We do not think that central banks have finished their work "normalising" bond yields, but for the time being, the current political and economic backdrop will not permit the continuation of the move to higher rates. We cannot see trade and other risks dissipating until later this year, at the earliest. Unfortunately, the risks facing the Canadian economy are even more acute and structural, pushing the timeframe for a change in Canada's prospects even further into the future.

Yield curves have flattened, and temporarily inverted, but we do not see recession as the likely scenario; nor, do we expect term premiums to remain negligible. However, low sovereign yields globally have continually triggered foreign flows into North American bond markets, depressing mid and long-term real yields. Unfortunately for the Fed (and the BoC) normalising yields, especially further out the yield curve, has consequently not been entirely in their hands. Nevertheless, we believe positive economic growth and rising wages will eventually result in steeper yield curves. We expect yields to remain around current levels throughout 2019, although sensitive to changing sentiment surrounding political risks. We have elected to maintain a below-index duration, recognising the relatively long absolute duration of the benchmark index.

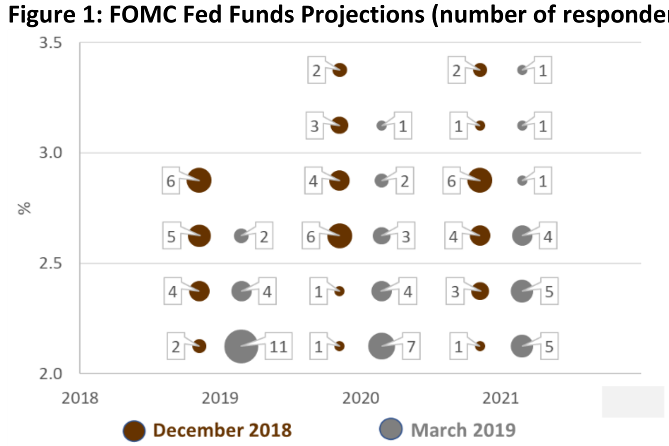
Equity and credit markets have benefitted from the curtailment of Fed Policy as investors have resumed the "risk-on" behaviour that so-characterised Powell's predecessor's tenures. Equity's have continued their 10-year bull market and corporate yield spreads have again narrowed. We would point out that, while equity prices are almost back to the levels at the end of Q3-19, corporate yield spreads are not. This is particularly true for lower quality, higher yielding credits, where yields are significantly higher than six months ago. We are comfortable holding credit, but our preference is for better quality issuers, especially as we move further out in term, where there is more spread risk and volatility.

The U.S.

There is no question that interest rate sensitive parts of the economy began to feel the chill from the Fed's steady path of rate increases and balance sheet unwind. Housing went on a consistent trend downwards as both existing and new home sales, and starts declined, particularly in H2. Auto sales also plateaued last year and then headed downwards in Q4. It is hard not to attribute some portion of the above slowdown to higher rates given the steady rise in wages throughout 2018 (average hourly earnings increased 3.2% yoy as at December), lofty equity markets until the Q4 correction, and the relatively high levels of consumer sentiment until year-end.

However, while the Fed has been tightening policy the White House has been doing its best (whether justified or not) to handicap the economy. The many trade battles that Lighthizer and co. have initiated have slowed international trade noticeably and have reduced global GDP. The US economy has not been spared the effects of trade conflicts despite only 12.2% of its economy (as at Q4 2018) being subject to trade – note the deterioration in US exports last year. Of course, the most noteworthy target of US trade policy is China who is suffering more than the US from the tariff war between the two; notwithstanding that China was already experiencing growth impediments given the extreme levels of public and private indebtedness. The ongoing wall/budget conflict between Trump and the House has also been negative for growth, having precipitated the government shutdown that lasted for 5 weeks. Finally, the Trump tax cuts now seem a distant memory, with much of the benefit (to confidence and otherwise) having already worked its way through the economy.

Figure 1: FOMC Fed Funds Projections (number of respondents)



Source: Federal Open Market Committee & Lorica Investment Counsel Inc.

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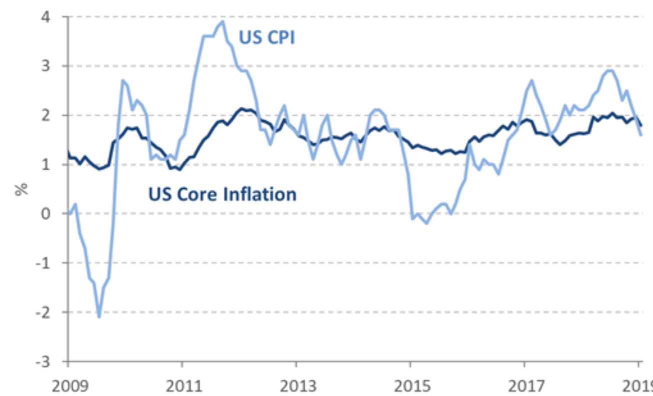
The plots have been re-dotted – as in the FOMC participants' assessments of appropriate monetary policy (midpoint of target range or target level for the federal funds rates – see Figure 1); and the futures market has been repriced – as in the Fed Funds Futures contracts (see Figure 2). It has not taken the Fed and the markets long to move from hikes in 2019 to no hikes and maybe even an ease. We had maintained that the Fed had not really been fighting inflation – core inflation has been benign (see Figure 3) – but was on a mission to normalise policy rates and the yield curve. They got stopped out in Q4, before they achieved their goal, but we don't think their game is over yet. The US economy slowed noticeably late last year and lost more momentum as the calendar turned. However, as of now, yields have fallen, "risk-on" has reasserted itself, and the uncertainties plaguing the economy seem unlikely to get worse.

Figure 2: Hike/Ease Expectations – Fed Funds Futures

Source: Bloomberg & Lorica Investment Counsel Inc.; March 2019

We are not overly concerned about the US economy, and one should not forecast its demise, simply because of the duration of the current expansion – at 117 months, soon to be the longest on record (the previous was 120 months from March 1991 to March 2001). Growth will have trouble reaching the 3%+ levels of the 90's given the constraints imposed by the decreasing availability of labour – the unemployment rate is now at 3.8% and job openings have continued to rise, now close to 5% overall (see Figure 4). The Fed has done its part by taking its foot off the break and we expect to see the government chip in with some friendlier actions on trade, especially as the election nears. The most recent data have interrupted the downward trends from the latter part of last year– housing, consumer and business spending, etc. have rebounded, although not yet entirely convincing.

Figure 3: US CPI & Core Inflation

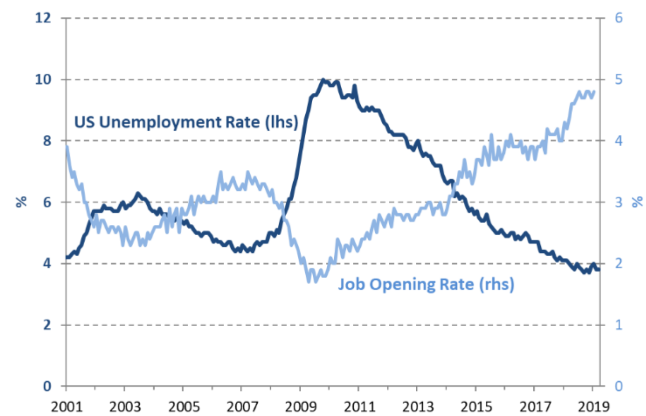


Source: Bloomberg & Lorica Investment Counsel Inc.; January 2019

Canada

We have concerns for the Canadian economy, despite our relative optimism for that of the US. The vulnerability of Canada's economy to weak energy prices, is by no means new or insightful. However, the changing dynamics around oil prices relating principally to US supply and the inability for Canada to optimize its own supply (i.e. delayed pipeline construction) have had a profound impact on Canada's growth prospects. Add in the US nationalistic sentiments that have dented US-Canada trade (despite the agreement to a renewed trade relationship, albeit yet to be ratified by Congress) and we are faced with an economy that cannot easily rely on trade for economic growth. However, relying on domestic consumption is also problematic, considering how overindebted Canada's governments and consumers are (see Figure 5).

Figure 4: US Employment & Job Openings



Source: Bloomberg & Lorica Investment Counsel Inc.; March 2019

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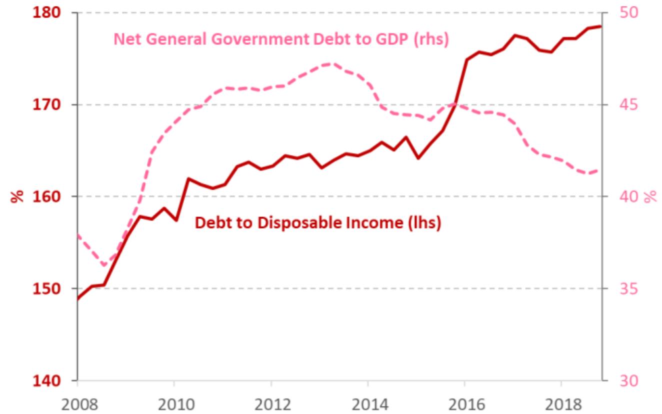
Figure 5: Canada Consumer Debt / Disposable Income & All Government Debt / GDP



Source: StatsCan & Lorica Investment Counsel Inc.; December 2018

We think the housing market has already been milked as much as possible this expansion and believe that relying on it to underpin the economy, even with lower mortgage rates, is unlikely. Various levels of governments have been forced to apply macro-prudential policies, to slow price increases, contain consumer mortgage risks, and discourage foreign ownership, that we do not see as reversing in the near-term. It was a surprise that in the recent budget the government included provisions to encourage more borrowing by first time house buyers, but we don't expect this to provide a meaningful bump to anything but millennial votes.

The high levels of Canadian government debt to GDP (now at 41.4%) have not stopped the federal government from spending – a balanced budget is now, nowhere in sight (the deficit is budgeted to run from -19.8 to -9.8 Billion from now to 2023-4 but could change after the election). Perhaps the appreciably worse financial tally south of the border (federal debt to GDP at 78%) makes it more palatable to Canadian citizens? Here, no-one seems to be interested in anything other than SNC-Lavalin and the NHL playoffs. Nevertheless, we don't foresee a significant growth impact from the recent budget. And we are still yet to see a major growth impact from the Infrastructure Bank – so far there has only been one announcement of a project refunding.

The Bank of Canada has taken interest rate hikes off the table for the time being but is not ready to signal a wholescale reversal of policy – they kept the prospect for rate increases in their most recent policy announcement in March when they stated the "increased uncertainty about the timing of future rate increases". However, Poloz's body language suggests there is more concern with trade – see his comments in Iqaluit on April 1, 2019. Poloz does point out that the news is not all bad, with employment strength and wage growth reflecting the gain in services, particularly technology related, some of which are also export-oriented. However, service exports is a gradual development that will be outweighed by trade and housing concerns that will keep Bank policy stimulative.

Yields & Yield Spreads

North American yield curves were quick to respond to weaker data in Q4, falling rapidly in November and December. Yields were then relatively stable during January and February, after which yield curves resumed their decline in March. (See Figure 6.) The initial move downwards was characterized by the flattening of the yield curve (up to 10-years, 30 years lagged the move), leading some commentators to conclude that a policy error had been made by the Fed and the yield curve was reflecting that a recession lay ahead. Recall that an inverted yield curve has had a pretty good track record of predicting recession – the US yield curve as defined from 3-month treasury bills to 10-year treasury notes is the one that has the perfect track record. The subsequent policy "fade" by Chairman Powell did not re-steepen the yield curve, but rather pulled overall yields down further.

Figure 6 shows the yield changes for Treasuries and Government of Canada's along the yield curve for Q4-18 and Q1-19 also split into real yields and implied inflation expectations. In the Q4 move, the decline was mostly about falling inflation expectations, which was consistent with falling CPI inflation (see Figure 3) which had risen to the highest level since 2011 during the past summer. Falling energy prices and slowing global trade contributed to inflation's decline. In the Q1 decline, the move was mostly about falling real yields, which was consistent with the abrupt turn in growth indicators and the change in central bank policy. The real yield curves are extremely flat (but off their floors of five years ago) – long term RRB and TIP yields have fallen to 0.44% and 0.90% respectively.

Short term real interest rates for Canada and the US are 0% and 0.5%. In the US, real yields are not that far off the theoretical estimate for r* or the real neutral rate of interest[†] for the US which has declined steadily to 0.81%. The neutral rate of interest has assuredly fallen and is not about to rise to

[†] See www.newyorkfed.org/research /policy/rstar, "Measuring the Natural Rate of Interest," R-Star for the United States, LW Estimation, and Laubach-Williams 2003, Working Paper Version (pdf).

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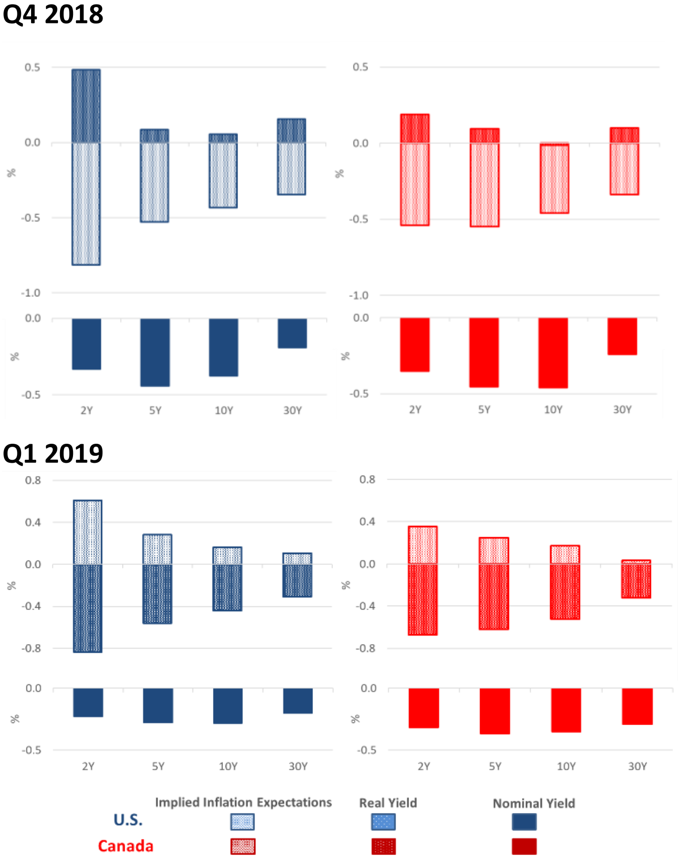
the levels seen a decade ago. However, the inability of real yields to expand despite years of stimulus from central banks across developed economies is troubling. The interconnectedness of global markets is partly responsible, but so too are unfavourable demographics, modest wage growth, the poor state of consumer and government balance sheets, and deteriorating trade relationships.

Figure 6: Quarterly US & Canada Real Yields, Implied Inflation & Nominal Yield Changes by Term



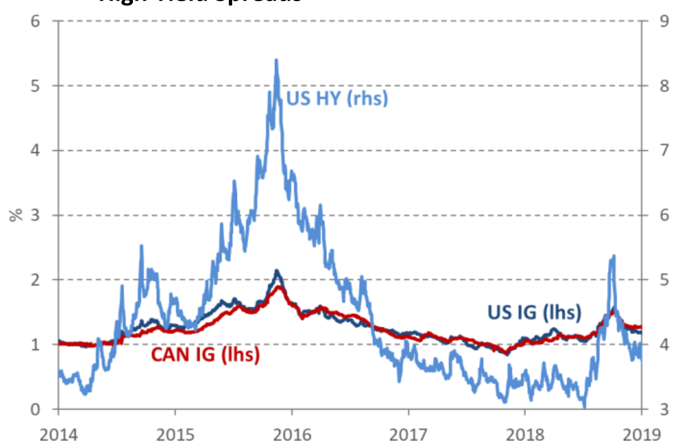
Source: Bloomberg & Lorica Investment Counsel Inc.; March 2019

Higher rates and weaker growth expectations contributed to wider credit spreads during Q4. Lower-rated credits in the US were particularly hard hit with high yield spreads widening by as much as 228 bps from 3.03% to 5.31% (see Figure 7). The lack of market depth, especially for less liquid, non-investment grade credit was particularly evident during the recent widening episode and has clearly given investors reason for pause. Following the tempering of Fed policy, corporate spreads have reversed in Q1. Investment grade spreads have recouped 70% of their spread widening since the peak in January, while high yield spreads have only recouped 61%. We are sceptical that investors will be willing to chase corporate yield spreads back to their lows of the last couple of years.

Canadian corporate bonds generally faired well amidst the negative sentiment towards risky assets that emerged in Q4 (see Figure 7). The concentration of high-quality issuers in Canada, together with a stable investor base in addition to an influx of foreign buyers meant that Canadian corporate yield spreads were relatively stable. There was however, a preference for short-term credit, which resulted in a steepening of the credit spread curve.

Liquidity continues to be an issue for corporate bond markets everywhere, a consequence of market dynamics including smaller inventories kept by broker-dealers, growth of passive strategies such as ETF's and upped participation in corporate bond markets by cross-over (non-bond specific) investors. We remain attentive to factors affecting the liquidity of individual issues when structuring our portfolios.

Figure 7: US & Canada Corporate Investment Grade & High Yield Spreads



Source: Bloomberg & Lorica Investment Counsel Inc.; March 2019

Gary Morris, CFA
President
T. 647.776.8111 E. info@loricaic.com www.loricaic.com