LORICA
INVESTMENT COUNSEL INC.

Focused Fixed Income

February 2020

Market Highlights

Last month we wrote: “That was certainly one of the more eventful January’s in recent memory… Australian wildfires, downed Ukrainian Airline planes, US-China trade deal, US-Mexico-Canada trade deal, the coronavirus, the Trump impeachment trial, Brexit…” Well, January was clearly just a precursor for an even more eventful February; and whereas the coronavirus was one of many events in January, it has become the “only” event of any real importance in February, and likely March.

US and Canadian bond yield curves finished the month substantially lower than where they started with US 2, 5, 10 and 30-year yields down by 42, 40, 37 and 34 basis points, respectively and Canada 2, 5, 10 and 30-year yields down by 29, 20, 15 and 12 bps, respectively. The outperformance of the US bond market – German and Japanese 10-year yields fell by only 17 and 9 bps, respectively – reflects the overwhelming flight to safety and yield advantage of the Treasury market, still the best safe haven for investors.

Investment grade credit, not surprisingly, underperformed Canadas during February; but yields still fell as investors showed few signs of panicking in the face of yet another crisis. It should be noted that the current crisis does not show signs of morphing into a financial one (with aggressive support by central banks) and is clearly displaying different market behaviour from the “credit crisis” of a decade ago. Canada corporate 2, 5, 10 and 30-year yields spreads widened by only 8, 12, 11 and 14 bps respectively, while provincial spreads of the same terms widened by 2, 7, 9 and 10 bps, respectively. High yield credits were another story, as the “already” vulnerable sector – tight yield spreads and weak fundamentals – displayed its vulnerability with significant spread widening. Yield spreads in the liquid US High Yield Index rose by 109 bps over the month, easily outpacing the decline in underlying Treasury yields.

Underlying economic news was secondary as the month progressed as investors became increasingly focused on real-time COVID-19 transmission information in an effort to predict the eventual economic impact. The Indigenous crisis in Canada, that earlier in the month stalled rail transportation across the country, was quickly forgotten as the unwinding of blockades coincided with the global expansion of the virus. In the US, there was some suggestion that Bernie Sanders success in some of the primaries was responsible for part of the decline of the stock market and bond yields, but Biden’s recent successes, with no substantial reversal of the capital market trends, suggests that focus is squarely on the coronavirus.

It is instructive to examine the progress of the analysis related to the virus and the corresponding market behavior. Initially there were comparisons to SARS and other more isolated viruses suggesting that the outbreak may be confined to China with most of the economic impact coming from the effects of the virus on the Chinese supply chain. Next, as the virus migrated to South Korea, Iran and Italy (not necessarily predicted by dominant patterns of China outbound travel), attention was diverted to the potential for the virus to spread quickly around the world with much broader supply impacts. Now, with the spread of the virus to all parts of the globe a certainty, and with experts predicting more widespread caseloads in developed countries, markets have begun to discount the reality of much slower economic growth as many parts of the economy are exposed to declining demand. But it is clear we are in a fluid environment, with investors reacting to real time information, with little precedent.

Outlook & Strategy

The coronavirus has thrown a wrench into any outlook that one may have had for the economy at the end of January. Even those who may have been pessimistic, will have notched their expectations down. We had been optimistic that the US and Canadian economies would continue to muddle through 2020, possibly with a little help from the central banks. We thought US and Canadian yields may continue to be volatile but ultimately would not trend in any direction, and that the Canadian yield curve would ultimately steepen from its stubbornly flat shape.

The outlook is now very uncertain and hinges on variables that are impossible to predict. Will the virus spread further and in which countries or will it be contained and where? While the virus appears not to be spreading further in China, it remains to be seen if that will be the case once the country gets back to work (and school). And is the Chinese experience representative of what should be expected in other parts of the world, with less resources and less authoritarianism? Once China acknowledged it was dealing with a deadly virus, it quarantined large portions of its population, an action that cannot be easily repeated in most other countries.

There will undoubtedly be a negative economic impact from what has happened thus far on account of COVID-19, either directly or indirectly – the OECD expects 0.5% less growth (with the potential for a bigger reduction). And there will likely be knock-on effects to the global economy due to behavioral changes by large segments of the population, either made willingly or imposed. The duration of these effects remains uncertain and will determine whether-or-not there is a recession, and if so, how deep. For now, markets are discounting the possibility of recession, with the outcomes more-or-less binary. In due course, we will have a better understanding if the distribution of outcomes leans one way or another. At the current time, we expect slower growth and are not yet inclined to predict a recession. However, this forecast could change quickly.

Canadian bond yields have declined significantly, on the back of easing from both the Fed and the Bank of Canada, and the likelihood of slower economic growth. Government and high-quality corporate bond yields have fallen across the yield curve. Further spread of the coronavirus will lead yields lower, while signs of containment will trigger a rebound. A rapid spread of the virus with vigorous government response in the form of quarantine and restrictions would also likely lead to more economic harm and more yield spread widening.