LORICA
INVESTMENT COUNSEL INC.

Focused Fixed Income

March 2020

Market Highlights

In hindsight, it was a gross understatement when we suggested in January's commentary that the year had gotten off to a troubled start, referring to a variety of events. The entire year will, no doubt, be remembered for the coronavirus, and the quarter, will likely drift into irrelevance. Although the data for the end of March looks bad (a 700,000 drop in US payrolls), they will not look that bad once April's payrolls, that capture more of the quarantine effect, or summer's unemployment rate reflect permanent job losses (assuming the quarantines are over by then) are released. For the most part, over the next few months, leading data will be difficult to make sense of or translate to economic growth and will be more frightening than anything.

Bond market performance has been what one would expect during a crisis with strong returns for sovereigns and weak returns for credit. In Canada, 2, 5, 10 and 30-year yields fell by 127, 110, 100 and 46 basis points, respectively over the quarter compared with bigger declines in the US of 132, 131, 125 and 107 bps. Yield curves have steepened enormously on the back of big policy rate cuts in both Canada and the US – policy rates are at zero or near-zero in developed countries around the world. The 2-30's Canada and US yield curves went from 7 and 82 bps, respectively at the beginning of the year to 88 and 108 bps respectively at quarter-end.

Corporate yield spreads underwent significant widening despite the enormous number of backstops put in place to secure business and bond markets. For the quarter, short, mid and long-term corporate yields rose by 44, 45 and 43 bps respectively. Although yield spreads widened by an average of 140 bps across the yield curve, this was partially offset by the large short-term yield declines of underlying Government of Canadas. Investors relied on the sale of short and mid-term corporates to meet liquidity needs (being the least impaired assets), which meant that long-term corporate prices remained opaque with wide bid-ask spreads (approximately 2-4% of market value for 30-year bonds) and insufficient trade points (over half of long-term issues did not trade in the final half of March). The selloff in credit was more acute south of the border where investment grade and high yield spreads widened by 179 and 543 bps respectively. The Canadian outperformance is largely due to our credit markets consisting of predominantly higher rated issuers with regulated domestic-centric business models and less exposure to cyclical, commodity and unintegrated energy businesses (many of which primarily issue in the high yield or US markets).

Portfolio Activity

The portfolio was structured defensively on a yield curve (steepening bias) and sector basis (illiquid, higher-beta credit to underperform) in accordance with our interest rate and sector forecasts, therefore trading was limited to the reinvestment of coupons into existing positions where needed.

What Worked In The Quarter

The portfolio benefitted from yield curve steepening as the portfolio's term profile was more conservatively structured relative to the benchmark with an overweight in the short and mid-term (<10 year) area of the yield curve in lieu of long-bonds. An overweight concentration in short-term senior bank debt made gains from Bank of Canada easing and credit friendly regulatory actions. The overweight in telco debt was also good for performance as the sector outperformed, given its growing status as an essential service while most other sectors were caught up in the wave of credit rating downgrades.

What Did Not Work In The Quarter

The portfolio's overweight provincial exposure (7-20 year) came under pressure as index and pension funds relied on the sale of mid and long-term provincials (being the most liquid asset) to reduce exposure in that area of the curve. A flight-to-liquidity resulted in a widening of interprovincial yield spreads with the largest global issuers (ON, QUE) outperforming other provinces.

Outlook & Strategy

It is clear that the global economy will go into a severe recession this year. However, the depth and length of the recession will be primarily dependent upon human behaviour which will be a function of government/medical policy and culture. The scientists are pretty uniform as to what is necessary to bring the virus under control to not overwhelm healthcare systems (we assume overwhelming such systems is not a viable policy), but it remains to be seen how quickly this will happen in countries around the world. There is not yet uniformity about how countries will come out of isolation and what parts of the economies will return and when.

We believe that yields will remain low for an extended period of time – short-term yields are near their bottoms and we are not expecting a big move from longer-term yields. Monetary policy will be used primarily to maintain function of capital markets and facilitate government and corporate borrowing. We expect fiscal policy will do the heavy lifting to sustain businesses and households and kickstart the moribund economy. While corporate yield spreads have widened, we think there may be a more attractive entry point – there is no hurry and we will use the defensive nature of the portfolio to take advantage of this opportunity.