LORICA
INVESTMENT COUNSEL INC.

Focused Fixed Income

June 2020

Market Highlights

Government of Canada and US Treasury yields fell across most maturities in April and then remained in narrow trading ranges for the balance of the quarter, with a slight hiccup at the beginning of June that was negligible for all but 10-year and longer Treasury yields. Canada 2, 5, 10 and 30-year yields finished the quarter lower by 14, 24, 18 and 33 basis points, respectively as did Treasury 2 and 5-year yields by 8 and 21 bps, respectively; while Treasury 10 and 30-year yields were higher by 4 and 10 bps, respectively. The rise in longer Treasuries coincided with some optimism surrounding the economy related to improved high frequency US economic data.

Although the decline in Canadian government yields was over by the end of April, corporate yields continued to decline through June (e.g. FTSE Mid Term Corporate yields declined by an average of 42 bps over May-June). The implicit underwriting of riskier debt by the Bank of Canada (along with other central banks including the Fed) through asset purchase policies, that also include corporate bond purchases, allowed investors to ignore underlying economic and business risks and pursue credit in the new issue and secondary markets. The record volume of corporate issuance ($45.1B in Q2) amidst a still very uncertain economic outlook, did not deter investors from taking on more credit risk. Credit markets were supported by the Corporate and Provincial Bond Purchase Programs which accounted for secondary market purchases of $139M (largely symbolic) and $5.1B, respectively. However, consistent with the rules of the programs, the actual issues purchased were not disclosed (unlike for Government of Canada's).

Canadian bonds returned a lofty 5.87% and 7.53% for Q2 and YTD, respectively according to the FTSE Canada Universe Bond Index. For Q2, corporates were the best performer (8.09%), followed by provincials (7.68%), with Canada's (2.30%) well-behind. The Bloomberg Barclays US Aggregate and Corporate Indices returned 2.90% and 8.99%, respectively for Q2; and 6.14% and 5.02%, respectively YTD.

Portfolio Activity

In anticipation of bull flattening of the yield curve, the duration of the portfolio was increased early in Q2, through a swap of mid-term to long-term provincial bonds. Provincial credit spreads had widened in sympathy with credit markets despite the announcement of the Provincial Bond Purchase Program (PBPP) and easy financing conditions for provinces, both domestically and abroad.

What Worked In The Quarter

The portfolio's overweight in long-term provincial bonds benefitted from the subsequent bull flattening of the provincial credit curve on improved market sentiment and the implementation of the PBPP. Short, Mid and Long Provincial yields fell by 50, 58 and 63 bps over the quarter respectively. The portfolio's corporate term structure was more conservatively structured relative to the benchmark with an overweight in the short and mid-term (3-7 year) area of the yield curve in lieu of long-bonds. The Corporate Bond Purchase Program prompted a tightening of corporate spreads in the five year and under area of the credit curve. The corporate credit curve steepened by 41bps and the corporate overweight on a market value weighted basis added additional yield to the portfolio. The portfolio had no exposure to the industries harmed most by COVID-19 containment measures – e.g. airports, real estate issuers.

What Did Not Work In The Quarter

With improved market sentiment, lower-rated (BBB-), higher-beta and subordinated corporate debt issues outperformed, notwithstanding global potential downgrades reaching an all-time high. The portfolio's corporate exposure is concentrated in liquid, higher-rated issues.

Outlook & Strategy

We don't expect the North American economies to emerge quickly from recession. Already weak household (particularly acute in Canada) and business balance sheets have been severely damaged by the loss of income. The economies will not be able to rely on consumer spending (capital spending has long been diminished) to respond to stimulative monetary policies. Despite government support of households through subsidies and employment insurance, we expect consumers will respond to the uncertainty, rise of unemployment, reduced opportunity and desire for expenditure, weakened finances and most importantly, persistent social behavior restrictions by saving. This could very well represent a secular shift in household behaviour.

Through this period of uncertainty and recession, bond yields will remain low. We do not expect either US or Canadian policy rates will drop below negative, but they will stay near zero. Yields further out the curve will be anchored by stable short rates and low inflation – we do not expect the increase in money supply to be inflationary until well into the future. For now, both countries are employing QE to stabilise yields and credit spreads. However, expect to see, at some point down the road, QE used to further flatten the yield curve into the long end.