LORICA
INVESTMENT COUNSEL INC.

Short-Term Bond

June 2020

Market Highlights

Short-term Government of Canada and US Treasury yields fell 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 short-term yields. One, 2, 3 and 5-year Canada yields finished the quarter lower by 7, 14, 20 and 24 basis points, respectively as did Treasury yields by 1, 8, 12 and 21 bps, respectively. The slight rise in yields in June coincided with some optimism surrounding the economy related to improved high frequency US economic data.

While the decline in Canadian government yields was over by the end of April, corporate yields continued to decline through June (e.g. FTSE Short Term Corporate yields declined by an average of 46 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 short-term bonds returned 2.15% and 4.04% for Q2 and YTD, respectively according to the FTSE Canada Short Term Bond Index. For Q2, corporates were the best performer (4.20%), followed by provincials (1.85%), with Canada's (0.69%) well-behind. The Bloomberg Barclays Short-Term US Aggregate and Corporate Indices returned 1.74% and 1.39%, respectively for Q2; and 3.92% and 1.28%, respectively YTD.

Portfolio Activity

In anticipation of bull flattening of the yield curve, the duration of the portfolio was increased in early Q2 through the purchase of five-year 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. Also, several short-dated positions were called and refinanced, amidst the record corporate bond issuance. The proceeds from the called issues were reinvested into senior bank, insurance and pipeline issues.

What Worked In The Quarter

The portfolio's overweight in long-term provincial debt benefitted from the subsequent bull flattening of the provincial credit curve on improved market sentiment and the implementation of the PBPP. Short provincial yields spreads tightened by 27 bps over the quarter. Similarly, the announcement of the Corporate Bond Purchase Program prompted a 107 bps tightening of corporate spreads in the five year and under area of the credit curve. The portfolio's relative overweight corporate exposure was concentrated in outperforming pipeline, insurance, telecom and senior bank debt. The portfolio had no exposure to the industries harmed most by COVID-19 containment measures (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.