LORICA
INVESTMENT COUNSEL INC.

Focused Fixed Income

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Market Highlights

Government of Canada and US Treasury yield curves steepened during August, as short-term yields remained largely unchanged, while mid and long-term yields rose, albeit generally within trading ranges established since March. Notably, long Canada's have not established a well-defined trading range, as the decline in long Canada yields, following the initial decline and rebound in March, has lagged that of long Treasuries, only reaching a recent low point in early August. In contrast, after the initial move, long Treasuries fell to a low point in April and came close again in August. The FTSE Russell Universe Canada Index (modified duration: 7.25 years) returned -1.21% over August versus the Bloomberg Barclays US Treasury Index (modified duration: 7.06 years) at -1.10%.

The Canada yield curve has been markedly flatter than the US Treasury curve, measuring 89 and 134 basis points (2-30's) respectively at the end of August. There are a range of factors affecting both curves, despite the generally poor economic outlook for both countries. Both Canada and the US have indicated low-rate policies for the foreseeable future which should keep both front-ends almost locked at near-zero. (Negative interest rate policies are not on the table in either country and we are not expecting that to change.) Both countries are running significant deficits, which has meant significant government bond issuance and corresponding burdens on respective sovereign bond markets. Both countries have implemented quantitative easing policies to provide liquidity to the bond market and help digest the record amounts of government and corporate debt. However, the distribution and relative size of issuance, QE and investor demand (both domestic and foreign), and the additional liquidity and safe-haven status of the Treasury market will continue to differentiate the shapes of the Canada and Treasury curves.

Corporate bond market tone was generally good through August with good investor demand and limited primary issuance (which was almost exclusively BBB-rated). Corporate yield spreads narrowed by an average of 8 basis points across the curve, with steepening of the credit curve augmenting the steepening of the underlying Canada curve. Short-term credits continued to be well-bid as were higher beta issues, as concerns over BBB-rated credit with negative outlooks subsided.

Outlook & Strategy

The future of the virus and the economy remain unclear as they are inextricably linked. The resurgence of the virus in many parts of the US where opening-up appears to have been premature is indication that returning to normalcy too quickly is fraught with risks and failure. And while Canada has managed to contain the virus reasonably well during the summer months, early indications of "back to school" and "back to work" suggest that the fall may not be so kind. The Canadian economy has been hard hit, and cautious opening-up, while likely beneficial in the long-run, will not alleviate the problems in the short-run. The evidence, so far, leads us to believe that broader economic recovery will rest heavily on the success of a vaccine, whose ETA is still very much in question.

In the meantime, we don't expect the economy will 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 economy will not be able to rely on consumer spending (capital spending has long been diminished) to respond to stimulative monetary policy. Despite government support of households through subsidies and EI, we expect consumers will respond to the uncertainty, rise of unemployment, reduced opportunity and desire for expenditure, and weakened finances 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 zero, 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.