LORICA
INVESTMENT COUNSEL INC.

Short-Term Bond

August 2020

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. Five-year Canada and US Treasury yields rose by 6 and 8 basis points, respectively during August, while remaining within 13 bps ranges, in both countries, since mid-June. One-to-five-year yields in Canada and the US have tracked very closely the entire year, while 10-year yields have come largely in-line since March. Long US yields are still trading at a spread to Canada yields, although the spread has narrowed since March to 34 bps, currently. The FTSE Russell Universe Short Canada Index (one to five years) returned -0.05% over August versus the Bloomberg Barclays US Treasury 1-5 Year Index at -0.06%.

The Government of Canada and US Treasury yield short-term (overnight to five years) yield curve are similarly flat, measuring 20 and 19 bps, respectively at the end of August. Although there are a range of factors affecting both yield curves, the impact is not likely to be felt in the short-end. The economic outlook is generally poor for both, Canada and the US, and both countries 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 large 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, further out the curve.

Corporate bond market tone was generally good through August with good investor demand and limited primary issuance (which was almost exclusively BBB-rated). Short-term corporate yield spreads narrowed by an average of 11 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.