LORICA
INVESTMENT COUNSEL INC.

Short-Term Bond

September 2020

Market Highlights

US Treasury and Government of Canada 5-year yields, both traded in a narrow range of 14 basis points during the quarter, whereas short-term yields were very stable, trading within single digit ranges, which is not surprising given the Fed's inflation targeting policy adjustment, announced in August, and the Bank of Canada's current review of its own targeting policy (expectations are for an adjustment similar to that of the Fed), coupled with a low expectation of negative rate policies. Longer-term yields were more volatile, perhaps a little surprising, but likely related to increased expectations for higher inflation in the not-too-distant future.

Some view higher inflation inevitable given the historical levels of monetary stimulus, while others are convinced that the high levels of unemployment (7.9% in the US, as at September) will not abate quickly nor permit higher inflation. The personal consumption expenditures ex. food and energy (the Fed's favourite inflation measure) fell from 1.8% yoy in Q1 to 1% yoy in Q2. However, the Fed's market measure of inflation expectations (the 5-year, 5-year forward inflation expectations rate) has risen from its March 19th historical low of 0.86% to 1.76% (current), still below the Fed's official long-term inflation target of 2% and well-below the average of 2.25% since 2003. The Bank of Canada's preferred measure of core inflation – CPI Trim, measures 1.7%.

While underlying government yields were largely range-bound during the quarter, credit spreads narrowed, especially in the short and mid-term areas of the yield curve. Despite the uncertain economic backdrop, investors displayed a propensity for assuming more credit risk, resulting in BBB corporates delivering the best performance of investment grade credits, with industrials, the best performing sector. Credit spreads did reflect investor concerns over the impending second wave of the coronavirus as spreads widened late in the quarter.

Portfolio Activity

With short-term rates well-anchored, the portfolio's neutral duration and yield curve exposure were maintained. The exposure to auto debt was increased reducing its relative underweight and capitalizing on the steepening of the credit curve. The portfolio's provincial, corporate and industry biases were maintained.

What Worked In the Quarter

The portfolio benefitted from its provincial overweight (market value and duration contribution) as short-term provincial spreads tightened by 7 bps over Q3. Spread narrowing was consistent across provinces as all continue to be well-ahead of funding schedules (70% completed half-way through fiscal year) and international demand remains strong. Short-term corporate spreads tightened by 35 bps over the quarter benefitting the portfolio's corporate duration overweight. Overweight exposures in insurance, pipelines, consumer staples and senior domestic non-systemically important bank debt outperformed. The portfolio was underweight utilities and infrastructure (no exposure to airports) which underperformed.

What Did Not Work In The Quarter

The portfolio did not have exposure to lower-rated real estate and non-viability contingent capital subordinated bank debt which outperformed along with more volatile risk assets; the portfolio's corporate exposure is concentrated in liquid, higher-rated issues.

Outlook & Strategy

The future of the coronavirus and the economy remain unclear. The emergence of a serious second wave in many parts of the world, including Canada and the US (it is debatable whether some parts of the US ever left the first wave), is inevitable; some countries are already there. The better economic environment of the northern hemisphere's summer months will have been a temporary respite, with the renewed tightening of constraints on economic freedoms and colder temperatures, imparting more pain on parts of the service economy, in particular. The evidence still leads us to believe that broader economic recovery rests heavily on the success of a vaccine – the ETA of which is still very much in question, or a game-changing treatment. We don't expect the economy 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 economy will not be able to rely on consumer spending (capital spending has long been diminished) to respond to monetary stimulus, indefinitely. 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, we expect to see, at some point down the road, QE used to further flatten the yield curve into the long end. While central bank QE programs have improved sentiment, the issue remains as to whether liquidity can solve deteriorating economic fundamentals, credit metrics and ultimately, solvency. We feel these risks are particularly elevated for speculative grade credit as the lifelines will only forestall and deepen creditor losses given increased COVID related headwinds for earnings and cash flows.