LORICA
INVESTMENT COUNSEL INC.

Short-Term Bond

October 2020

Market Highlights

The US Treasury and Government of Canada curves both steepened slightly over the month as yields moved marginally higher, but with the front ends in both countries remaining firmly in place. Corporate yield curves also steepened as credit spread curve steepening added to the underlying sovereign curve steepening. Investors showed a preference for shorter-term debt, given the level of uncertainty from a myriad of sources including the US stimulus stalemate, rising COVID-19 cases, upside (albeit lagging) growth surprises and the US election. The rise in five-year yields was 4 ½ basis points, not enough to move beyond the trading range established since March.

Corporates were the best performing Canadian sector of the investment grade universe, followed by provincials. Short provincial spreads were unchanged, clearly responding to the Provincial Bond Purchase Program, while appearing unaffected by deteriorating provincial finances. Short corporate yields spreads were narrower by 3 bps, as investors demonstrated a preference for shorter-term higher-quality credits, electing to lower credit risk by reducing exposure to lower-rated and longer-term issues. The weakest performers were the most liquid BBB-proxies from retail and telecom/cable sectors.

The Bank of Canada released its fall Monetary Policy Report towards the end of the month, in which it continued to highlight the uncertainties that lay ahead. Nevertheless, the Bank was willing to make economic projections (something they did not do in their April report) which showed a large 5.5% YOY hole in 2020, but 4% YOY recovery in both 2021 and 2022. Importantly for the bond market, the Bank made some adjustments to its quantitative easing program, whereby it will reduce the size of its purchases while focussing on longer benchmark maturities. This move allows the Bank to get a bigger “duration bang for their buck” and alleviate some liquidity concerns that have been created by the program.

The US election, while still being contested, appears conclusive, for all but the Senate where two outstanding seats from Georgia are still to be determined in a January runoff. The markets seem to be expecting Republican control of the Senate, which would result in a divided government implying less radical change from the policy environment of the Trump years. However, a double Democrat win would result in a Democrat-controlled Senate which we would expect the market to interpret less positively. Given the election outcome we do not expect agreement on a US stimulus package this year.

Although economic numbers continued their rebound through October, the concurrent rebound in COVID-19 cases from the summer lows, suggests that we may not see better economic numbers for the remainder of this year. While certain sectors of the economy continue to suffer, there has been some surprising resilience in certain sectors as households adjust their consumption patterns to deal with the pandemic-enforced change in lifestyle. Expenditures have shifted away from some areas such as leisure and hospitality towards others such as home improvement and entertainment. However, the shift from services to goods is not straightforward but rather more granular, as some goods and services have fallen out of favour (e.g. clothing and dining), while others have fallen in (e.g. sports equipment and home renovation).

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 has already started. 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. Unfortunately western governments have proven largely ineffective at gaining control over the virus, something we do not see changing imminently; although we could see some improvement in the US with a new government.

We don’t expect the economy to emerge quickly from recession. Already weak household (particularly acute in Canada) and business balance sheets have been 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 fiscal policy will continue to play an important role. However, we note that while households have increased savings, they have also redirected their consumption to reflect the realities of COVID-life.

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.