LORICA
INVESTMENT COUNSEL INC.

Short-Term Bond

November 2020

Market Highlights

While short-term Government of Canada yields were basically unchanged (rose by one basis point) during November (FTSE Russell Universe), short-term investment grade corporate yields fell by a whopping 17 bps while provincial yields fell by only 3 bps. Thus short corporate yield spreads narrowed substantially – 18 bps versus only 4 bps for provincials. In contrast, the Bloomberg Barclays US Short Term Corporate Index yield fell by 4 bps versus the US Short Term Treasuries Index yield which fell by 2 bps reflecting the fact that US short term corporate yield spreads had already reached tight levels in the spring.

The election and positive vaccine announcements overshadowed immediate concerns posed by the rising COVID numbers and consequences for the economy, thus giving fuel to risk investments. An election outcome (of any sort) and the growing unlikelihood of the outcome being overturned, removed one key source of uncertainty from the market, control of the Senate notwithstanding. While a divided Congress is a distinct possibility, the pros and cons for the economy and markets of such an outcome is debatable. For the time being, there is no agreement on a stimulus package – the Georgia senate vote may ultimately decide the magnitude of such a package. The other big uncertainty-reducing development was the very positive announcements from Pfizer and Moderna on the efficacy and initial safety of their respective vaccines. Regardless of the manufacturing challenges ahead, both announcements served to shorten investor expectations for the course of the pandemic.

In contrast to the optimism embedded in capital markets, the substantial second wave of the pandemic in almost all westernised countries is leading to weaker economic data. In the US and Canada, the hopeful data for the summer months has given way to more ominous data for the fall. Employment which had been growing through the summer, has again turned with more lockdowns being exercised across the continent. Consumer spending has also slowed, again a consequence of restrictions, and in spite of the increase in consumer income (due to government subsidies). The lockdown-economic situation in Europe is even more dire – for the moment – with the second wave having started earlier.

Bond markets have functioned effectively since the onslaught of the pandemic, supporting record levels of government and corporate bond issuance. Corporate bond QE has been largely superfluous, leading to the retirement of the US facility. The rationale for central bank QE has transitioned from market function to economic stimulus, which together with fiscal policy will be key elements of economic recovery. In Canada, the government's Fall Economic Statement is clear about further stimulus through wage and rent subsidies. While aggressive fiscal policy from the Canadian government should reduce the reliance on policy stimulus from the Bank of Canada, Bank policy may still be required to keep a lid on bond yields. The lack of a stimulus package in the US, and the potential for an undersized package when one is eventually – we expect this to be the case – delivered, could very well force the Fed into more aggressive QE or even yield curve control.

Outlook & Strategy

The future of the coronavirus and the economy still remains 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 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 emergence of viable vaccines – the ETD (distribution) of which is very much in question – has produced some light at the end of the tunnel but will not be delivered quickly enough to avoid the hardship of winter lockdowns. Substantial additional fiscal stimulus will support households but will not be a complete substitute for reduced employment. We note that households have increased their savings while having also redirected their consumption to reflect the realities of *COVID-life*. We would expect that as uncertainly of the future dissipates over time, some of the built-up savings, will flow back into the economy. (We are hopeful that some savings will remain on improved household balance sheets.)

Through this period of uncertainty, weak economic growth and widened output gap, bond yields will remain low. We do not expect either US or Canadian policy rates will drop below zero but 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. However, any pressure pushing bond yields higher, is likely to result in additional QE to support the yield curve into the long end.

Significant progress on vaccines coupled with government and central bank policies have contributed to positive market sentiment. However, lockdowns and resulting weaker economic fundamentals, will challenge credit metrics and in some cases solvency. In the Canadian market, which is dominated by investment grade credits, leverage metrics remain elevated, but debt servicing metrics are healthy and refinancing risks are not a near-term threat, even amongst the lowest rated names.