

## Market Highlights

Canadian short term bonds returned a healthy 5.29% in 2020 versus 8.68% for universe bonds (FTSE Russell Canada Universe Bond Index), pretty good compared to Canadian equities which returned 5.60% (S&P TSX). However, equities still dominated the headlines because of the lofty returns in the US: 18.40% (S&P 500) due to technology stocks benefitting from the pandemic. Although Canadian short term bond returns were high for the year, it was a case of halves: 4.04% in H1 versus 1.20% in H2. The prevailing theme in the first half was the decline of government yields, led by lower policy rates and quantitative easing. Corporate yield spreads widened dramatically in March, but retraced 2/3's of the move by mid-year, retracing the remainder by year-end.

There was a gradual but limited steepening of the Canadian yield curve during Q4, as optimism surrounding vaccines and recovery in 2021 made its way into investor psychology. Lockdowns, which are still very much alive, seemed to be yesterday's news, despite continued disappointing economic data. Unemployment rates are still very high: 6.7% and 8.5% in the US & Canada, respectively; and consumer spending, supported by significant government subsidies, is still very weak overall: -2.4% and -4.5% from levels from a year ago in the US & Canada, respectively. The one shining area has been housing with fall home sales peaking close to 7 million (SAAR) in the US and 700,000 (SAAR) in Canada.

Corporate bonds, underpinned by supportive monetary policies, outperformed governments in 2020 – mid-term corporates returned 11.14% vs 8.92% for Canadas and 9.97% for provincials of similar term (FTSE Russell Canada Mid Term Bond Index). The prominence of high quality investment grade credits and the relatively narrow breadth of industries in the Canadian bond market limited the number of credits severely impacted by the pandemic; whereas the US, with a much higher proportion of speculative credits, saw more significant downgrades. In North America overall the percentage of companies rated CCC+ or lower by S&P (mostly in the US) was 50% higher in December than a year ago.

## Portfolio Activity

To capitalize on credit curve steepening, exposure to pipeline and senior domestic bank debt was increased via a reduction in shorter-term (<1 year) retail and legacy bank deposit notes. The duration, yield curve, sector and credit quality biases were maintained.

## What Worked in the Quarter

Narrowing of the provincial credit spread curve benefitted the portfolio as short-term provincial spreads tightened by 6 bps over the quarter, given the portfolio is overweight provincial credit on market value and duration weighted basis. Similarly, the portfolio's overweight exposure to short-term corporates benefitted from 29 bps of corporate credit spread narrowing over the quarter. The portfolio also benefitted from overweight exposures in outperforming issues of pipeline, insurance and autos and underweight exposures in underperforming issues of utilities, infrastructure, retail, pension and securitization.

## What Did Not Work in the Quarter

The portfolio did not have exposure to lower-rated and less liquid issuers in real estate and mortgage finance which, along with more volatile risk assets, underperformed.

## Outlook & Strategy

The future of the coronavirus and the economy is slowly becoming clearer. The arrival of several effective vaccines promises an end to the pandemic in the foreseeable future. However, the road to that end will be bumpy and uncertain, with waves of the pandemic and lockdowns likely until vaccination is widespread and herd immunity has been achieved. Capital markets suggest investor optimism of rapid success in 2021. We are hopeful, but doubt that the consensus 2021 GDP forecasts of 4.4% for the US and 3.9% for Canada (Bloomberg) will be achieved.

The Christmas/New Year induced pandemic waves together with the more contagious mutations of the virus will make it difficult for western economies to open-up in Q1. Q2 could also be a problem. By mid-year we are optimistic that vaccinations and less restrictions will permit more economic activity. In the mean-time economies will be challenged and will count on government subsidies (until the pandemic subsides debt burdens will continue to be tomorrow's problem). The democrat presidency and congress majorities can be expected to boost support for households, as can the Liberal government. However, don't expect households to stop saving a substantial portion of support.

Through this period of uncertainty and weak economy, 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. However, any pressure pushing bond yields higher, is likely to result in additional QE to support the yield curve into the long end.

Central bank QE programs have improved market sentiment, but 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 further COVID related headwinds through the winter for earnings and cash flows.