LORICA
INVESTMENT COUNSEL INC.

Focused Fixed Income

January 2021

Market Highlights

Five-year and under US Treasury and Government of Canada yields were basically unchanged during January. However, long Canada yields followed the lead of long US Treasury yields higher early in the month, but remained relatively stable thereafter, resulting in steeper government yield curves over the month. Despite more troubling economic prospects due to COVID restrictions on consumer activity, corporate yield spreads narrowed (with a greater narrowing for longer maturities) contributing to the outperformance of corporate bonds.

The continuing evolution of the virus and related biopharma developments along with the unpredictable and often inappropriate responses from politicians means that the progress of the economy is difficult to predict, thereby making identifying economic trends all but impossible. Fourth quarter GDP was initially thought to be more promising, but late-year COVID-restrictions have resulted in disappointing growth with the US BEA Q4 advance estimates falling below the already downgraded leading economist forecasts. January restrictions are also generating a much poorer Q1 outlook. The initial optimism surrounding the success of certain vaccine trials has been somewhat replaced by the reality of the manufacturing and distribution challenges and the emergent understanding of virus mutations and their contagiousness.

Despite the uncertainty of the future, longer term yields are at their highest levels since last April. It is difficult to identify the precise catalyst for the rise of yields during January given: that the near-term outlook for the economy looks more uncertain considering virus mutations and vaccination challenges; central banks have been unwavering with their forward guidance on policy rates and are notably open to more targeted QE; inflation expectations did not materially change – the 5-Yr, 5-YR Forward Inflation Expectation Rate is stuck at 2%; and the wide gulf between democrat and republican fiscal policy.

January was a particularly difficult month for Canada with heightened COVID cases, the Biden executive orders confirming cancellation of the XL pipeline and strengthening Buy America policies, and the series of disappointing target reductions for Canadian deliveries from all of the manufacturers of Canadian government approved vaccines. While none of the above should have been much of a surprise, both US-Canada yield spreads and the Canadian dollar did reverse course during the month.

Outlook & Strategy

Just when it was beginning to look like the future of the coronavirus and the economy was becoming clearer – new variants and the complexity of vaccine distribution have emerged as underestimated stumbling blocks. Perhaps the lesson to be learned is that until the virus is well and truly gone, we should expect the unexpected. Still, vaccines promise an end to the pandemic, with the road to that end bumpy and uncertain, as waves of the pandemic and lockdowns will likely persist until vaccination is truly 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 GDP forecasts 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. Not all countries will be treated equally as vaccine supply will remain scarce for some time. In the US, vaccinations should permit more economic activity by mid-year, while Canada will unfortunately lag due to no domestic vaccine manufacturing capacity. We expect economies will be challenged for some time and will depend on central bank and government 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 – the increase in money supply will not be inflationary until well into the future. For now, both countries are employing QE to stabilise yields. However, any pressure pushing long yields higher, is likely to result in additional QE to support the yield curve into the long end.

Through the pandemic the credit markets have benefitted from the lowering of sovereign yields and central bank commitments to maintain easy monetary policy and market liquidity. However, there is still the question as to whether excess liquidity can solve persistent challenging economic fundamentals, weak credit metrics, and ultimately, solvency. In the domestic market, which is dominated by investment grade credits, leverage metrics remain elevated, but debt servicing is healthy and refinancing risks are not a near-term threat, even amongst the lowest rated names.