LORICA
INVESTMENT COUNSEL INC.

Focused Fixed Income

March 2021

Market Highlights

The Canadian bond market returned a very poor -5.04% (FTSE Canada Universe Index) for Q1 – the weakest quarter since Q1 1994, on the back of February's -2.52% - the weakest month since March 1994. The backup in yields was prompted by optimism for a rapid economic recovery in the US on the back of anticipation of widespread vaccination and expectations that households will quickly resume pre-pandemic activity. Although vaccinations in Canada are lagging the US by a significant margin (those receiving at least one dose was 13% in Canada vs. 29% in the US per capita as at the end of March), expectations are clearly for Canadian growth to be pulled-up by the US.

Recent US economic data has been positive, but not universally so: e.g., employment (916,000 for Non-farm payrolls versus 10.7% for U-6 or underemployment), ISM (64.7 for manufacturing & 63.7 for services) versus home sales (-6.6% existing & -18.2% new); and confidence (109.7 Conference Board versus 84.9 U. of Michigan). However, investors have clearly decided to focus on the near-term trajectory rather than weak comparables or impediments to the longer-term. Recent Canadian data was also surprisingly positive despite the breadth of lockdowns still in place: e.g., housing (2.1% for building permits) – albeit perpetually strong, manufacturing (58.5 Markit survey), and confidence (64.1 Bloomberg Nanos).

Corporate bonds outperformed government bonds during the quarter, as yields spreads narrowed 4 basis points on average, with short corporate spreads rising by 5 bps, and mid and longs narrowing by 7 and 10 bps, respectively. However, any spread narrowing was easily offset by the bear-steepening of the underlying Canada yield curve, resulting in poor absolute returns and contributing to the flattening of credit spread curves. Corporate issuance was robust during February and early-March as issuers rushed to finance in response to spiking yields, but waned towards the end of the quarter, leading to tighter spreads. Lower-rated, higher-beta issues outperformed during the period.

Portfolio Activity

To capitalize on yield curve steepening and a flattening forecast, exposure to mid and long-term provincial and mid-term senior domestic bank debt was increased through a reduction in shorter-term positions in pipelines and provincials. The duration, sector, industry and high credit quality biases were maintained.

What Worked In The Quarter

Bull flattening of the provincial yield spread curve benefitted the portfolio as long-term provincial spreads tightened by 5 bps over the quarter. The overweight in long-term provincials included an overweight of Alberta, Saskatchewan and Manitoba debt, which were amongst the top performing provincial issuers. The portfolio also benefitted from overweight exposures in pipeline (TC Energy and Enbridge) and insurance (life insurers) issues which outperformed and was underweight utilities, infrastructure, pension and securitization debt which underperformed.

What Did Not Work In The Quarter

The portfolio possesses a relative higher credit quality on a duration weighted basis and did not have exposure to lower-rated real estate, mortgage finance, retail, hybrid and financial services debt which outperformed along with more volatile risk assets. The duration, although neutral to the benchmark was long in absolute terms, and therefore not positive for absolute performance.

Outlook and Strategy

As we move further into the vaccination phase of the pandemic, the distribution of vaccines has become the primary focus of investors and their outlook for the economy, superseding the spread of variants and the effectiveness and magnitude of policy response. However, more contagious mutations of the virus and lack of vaccine will make it difficult for many economies to open-up. In the US, widespread vaccinations should permit more economic activity by mid-year, while Canada will unfortunately lag due to no domestic vaccine manufacturing. A European recovery, despite domestic vaccine production, will also lag, exacerbated by strict lockdowns, which are still plaguing much of the continent, and slow vaccination (only 12% per capita of the EU have received doses). In much of the developing world (China being a notable exception) the virus and mutations, which continue to surge with substantial vaccination still way off, will impart an economic impact. Capital markets suggest investor optimism of rapid vaccination success coupled with substantial fiscal support in 2021 – while we are hopeful, we are doubtful of the consensus GDP estimates.

The US yield curve is predicting recovery and heightened inflation – we think the move is overdone. We believe that central banks will not raise rates for some time and that yield curves cannot remain as steep without some hint of monetary tightening – none will be forthcoming from the Fed or the BoC. Furthermore, while inflation will temporarily be underpinned by weak prices from a year ago, a secular rise is not imminent. We expect some flattening of the US yield curve to lead to flattening of the Canadian yield curve.

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 stretched 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.