LORICA
INVESTMENT COUNSEL INC.

Short-Term Bond

March 2021

Market Highlights

The Canadian short term bond market returned -0.59% for the quarter (FTSE Canada Short Term Bond Index), significantly outperforming the overall bond market which returned -5.04% (FTSE Canada Universe Bond Index). The backup in yields was negligeable for maturities of 2-years or less but increased linearly to the 7-year area where the increase out to the long-end was between 75-85 basis points. The backup 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. The short-end was kept stable as central banks indicated that monetary policy would not change any-time soon.

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).

Short corporate bonds outperformed short government bonds during the quarter given a relatively minor (5 bps) widening of yields spreads. However, the spread movement was dwarfed by the rise of 3 to 5-year underlying government yields, which resulted in negative absolute short corporate bond returns of -0.48% (FTSE Short Term Corporate Bond Index). 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, exposure to telecom and provincials was increased through a reduction in shorter-term (<1 year) pipelines and provincials. The duration, sector and credit quality biases were maintained.

What Worked In The Quarter

The portfolio's holdings are overweight in 1-3 year corporate and provincial bonds in lieu of 4 to 5-year issues as credit in this area of the credit curve provides more relative value. In addition to the yield enhancement, the yield curve steepened as 3 and 5-year yields rose by 24 and 60 bps, respectively. The portfolio also benefitted from overweight exposures in pipeline, insurance and auto issues which outperformed and was underweight utilities, infrastructure and retail debt which underperformed.

What Did Not Work In The Quarter

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

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.