LORICA
INVESTMENT COUNSEL INC.

Short-Term Bond

April 2021

Market Highlights

Longer-term US yields declined in April, reversing course from Q1 and bringing into question the notion of an imminent 2-handle for 10-year US Treasury yields. Both 5-year US Treasury and Government of Canada yields declined by around 7 basis points, with Canadian short-term yields remaining slightly higher than comparable US yields – a position they took earlier this year. A general flight to safety of Treasuries brought on by the pandemic, together with expectations that the Canadian recovery will lag that of the US and that the Bank will reduced its QE program before the Fed does, have likely contributed to US-Canada spread narrowing.

The front-end of the US yield curve continued to be firmly anchored during April, supported by the Fed's mantra that they are not concerned about inflation and indication that rates will remain low for the foreseeable future. The front-end of the Canadian curve has been more volatile, with the Bank of Canada appearing to be less dedicated to a prolonged zero interest rate policy. Nevertheless, Canada-US 2-year spreads are now at 12 bps, not significantly wider than what they have been through most of the pandemic.

US and Canadian economic data released during April were generally stronger than expected, although it is worth remembering that consensus estimates are more unreliable than usual given the unprecedented and volatile economic environment that we have been living through. Nevertheless, the behaviour of the bond market suggests that, in Q1, investors may have over-estimated the strength of recovery based on declining US active cases and accelerating vaccination rates. However, as we progressed through April, slowing vaccination rates, the suggestion that herd immunity may not be achievable, and the realization that much of the globe is still suffering through the pandemic and its variants have muted some of the initial optimism, ultimately translating into lower yields.

Outlook and Strategy

As we move further through the vaccination phase of the pandemic, the distribution of vaccines has become the primary focus of investors and their outlook for the US economy, superseding the spread of variants and the effectiveness and magnitude of policy response. Early evidence from populations with relatively high rates of vaccinations suggest that economies will be able to successfully open-up, albeit still with caveats and constraints. However, the virus will likely continue to be a problem for global economic growth as long as so much of the globe remains unvaccinated and significant portions of vaccinated populations resist vaccination.

In the US, widespread vaccinations should permit more economic activity by mid-year, and Canada – given the recent increase in available doses – will not be far behind. 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 rates. 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 both locally and globally.

The US yield curve is predicting recovery and heightened inflation – although we have seen some yield reversal, we think the curve steepening is still 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 rate increases – we do not think signals will be forthcoming from the Fed or the BoC. Furthermore, while inflation will temporarily be underpinned by weak prices from a year ago and supply/demand imbalances, we do not believe a secular rise is imminent. We expect further flattening of the US yield curve to lead to some 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.