LORICA

Focused Fixed Income

June 2021

Market Highlights

In June, bond investors decided to ignore the data, listen to the Fed and retreat from the inflation trade, buying long bonds and flattening the yield curve in the process. Through the first quarter of 2021, the themes dominating the US bond market were the strength of the economic recovery and elevated inflation, tactical short positions and asset mix shifts, all prompting the sale of bonds and steepening of yield curves. However, the recovery and inflation were and still are difficult to gauge as the pandemic has caused so many imbalances. The data has been volatile and extrapolating short term trends is fraught with difficulty.

Last summer, as the US was recovering from its first wave, employment growth was robust; it was assumed that the second wave recovery would be a continuation. However, that has not been the case as payrolls, after promising late-winter gains, were disappointing through Q2. The housing market too, has been somewhat unconvincing as well as volatile. However, inflation is still running high as supply shortages have not yet dissipated and uneven demand continues to plague many sectors.

Some of the bond market losses of the first quarter were reversed in the second (and the beginning of the third) with the FTSE Russell Canadian Universe Index returning 1.66% in Q2 and -3.46% YTD. In the US, the Bloomberg Barclays Aggregate Index returned 1.83% in Q2, more than halving the YTD loss to -1.60%. In Canada, provincial bonds were the best performers during the quarter (2.68%), with the long duration of the sector benefitting from the flattening of the yield curve. Although corporate bonds outperformed Canadas (1.28% vs 0.92%), the relative performance varied across the yield curve. In the short-end, corporates outperformed Canadas by 30 bps, whereas they were almost neutral in the mid area at plus 7 bps and underperformed in the long-end by 26 bps. On a duration adjusted basis, lower-rated credits outperformed for most of the quarter as investors continued their reach for yield. Notably, corporate spreads widened in June, although not enough to wipe out the sector's yield pickup.

Portfolio Activity

To capitalize on a back-up in short and mid-term corporate yields, the portfolio's exposure to senior domestic bank, telecom and pipeline credit was increased through a reduction of shorter-term (<1 year) positions in domestic bank and telecom debt. The duration, sector, industry and high credit quality biases were maintained.

What Worked In The Quarter

The portfolio was positioned for and benefitted from a bull flattening of the Canada yield and provincial yield spread curves. The overweight in long-term provincials – Alberta, Saskatchewan and Manitoba – were the top performing provincial issuers on improved fiscal projections. The portfolio's corporate holdings, which are overweight short and mid-term credits in lieu of long bonds, benefitted from bull steepening of the credit spread curve and the overweight in outperforming issues of senior domestic bank, telecom and pipeline debt. The portfolio also had no exposure to underperforming railways, airport, retail, utilities and securitization debt. Provincial and corporate overweights provided additional yield.

What Did Not Work In The Quarter

The portfolio has no exposure to lower-rated credit (BBB mid and below) or issues in real estate, mortgage finance, hybrid and financial services which, along with more volatile risk assets, outperformed.

Outlook and Strategy

For those countries with access to vaccines, the focus has shifted away from the virus to economic recovery. Although variants could still be problematic for highly vaccinated countries, given high levels of vaccine hesitancy and resistance, we think aggressive lockdowns are less likely (particularly in the US). Unfortunately, countries with limited access to vaccines will continue to struggle with the pandemic and their economic recoveries will lag. With the number of largely unvaccinated countries high, overall global growth will be disappointing as demand for exports remains weak.

We expect the US and Canadian recoveries to be moderate and drawn out – yield curves have already adjusted somewhat to this view. We do not expect central banks to raise rates for some time, although tapering of bond purchases is likely. While inflation will temporarily be underpinned by supply/demand imbalances and weak prices from a year ago, we do not believe a secular rise is imminent – we expect inflation expectations to eventually fall. We will maintain the flattening bias in the portfolio.

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. We will maintain the overweight to shorter maturity high quality liquid credits.