LORICA

Short-Term Bond

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 Short Term Index returning 0.07% in Q2 versus -0.59% in Q1. In the US, the Bloomberg Barclays Short Term US Aggregate Index returned 0.29% in Q2 versus -0.55% in Q1. In Canada, BBB-rated corporate bonds were the best performers in the short term area during the quarter (0.27%), outperforming provincials (0.17%) and well-ahead of Government of Canadas (-0.12%). Lower-rated credits outperformed 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-term corporate yields, the portfolio's exposure to insurance, senior domestic bank, telecom and pipeline credit was increased through a reduction of shorter-term (<1 year) issues. The duration, sector, industry and high credit quality biases were maintained.

What Worked In The Quarter

The portfolio was overweight provincial and corporate credit (by ½ and ¾ of a year on a duration-weighted basis, respectively), which provided additional yield, and benefitting from credit spread narrowing during the quarter. Provincial holdings (Alberta, Ontario & Quebec 2-4 year bonds) outperformed as their spreads tightened by an average of 11 bps on improved fiscal projections versus 5 bps for the benchmark. Additionally, corporate positioning in senior domestic bank, pipeline, telecom and auto debt, and no exposure to underperforming railways, airport, retail, utilities and securitization debt resulted in the portfolio's corporate yield spreads to narrow by an average of 5 bps versus 3 bps for the benchmark.

What Did Not Work In The Quarter

The portfolio's term structure was more conservatively structured relative to the benchmark with an overweight in 2 and 3-year debt in lieu of 5 year debt. While volatile, the short-term Canada curve (2-5 year) bear flattened by 20bps in Q2.

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.