LORICA

Short-Term Bond

August 2021

Market Highlights

Summer doldrums, pandemic exhaustion or simply well-balanced investor positioning – whatever the reasoning, Canadian and US bond markets continued their summer paralysis through August. Since mid-July, government and corporate yields in both countries have traded in very narrow ranges, with the deteriorating economic prospects having already contributed to the yield decline through the spring. The worsening COVID situation in the US and Canada, seems to have already been priced into the market, causing real yields to fall and Bank of Canada and Fed expectations to fade. The disappointing US nonfarm payroll number will likely take a September taper by the Fed off the table and provide them more time to see how debt ceiling and stimulus package negotiations progress. The market pricing for interest rate hikes from the BoC is also less aggressive than it was following the July interest rate announcement – December 2022 BA futures are pricing in 55 bps of hikes, compared with 70 bps in July.

US real yields are hovering around -1.0% post-nonfarm payrolls, compared with -0.59% in March and 0.1% before the pandemic struck. Similarly, in Canada following an unexpected Q2 growth contraction along with a weaker than anticipated July reading, real yields have fallen to -0.56%, relative to -0.21% in April and 0.2% prior to the pandemic.

The much-anticipated Fed confab at Jackson hole came and went without much fanfare – in reality it was just the quietude of the summer markets creating anticipation – with the Fed suggesting taper later in the year, albeit with the caveats to allow it to maneuver should conditions warrant. Inflation remains a point of contention, although not necessarily generating too many headlines. Central bankers are generally convinced that the elevated levels are only temporary, while a significant contingent of bond investors are short expecting the uptrend to continue. The most timely economic data suggests a slow down, yet with inflation pressures continuing to tick slightly higher – the US PCE Core Deflator came in at 3.6% YOY, 0.1% higher than the previous month (due to base effects) while the similar Canadian series (Core – Trim and Median) were also higher.[1] Though uncomfortably high, consumer and business inflation expectations in Canada were well contained through Q2, a point in favor of the transitory position.

Outlook and Strategy

The virus remains the wildcard for the bond market. Although most developed countries are progressing through vaccination programs, given the reality of vaccine hesitancy and resistance, the fact that much of the developing world is not vaccinated, and the rapid transmission of the Delta variant, we believe that the virus will remain a threat to economic growth for some time. The bond market had gotten ahead of itself at the end of Q1, with lofty growth expectations, despite much of the world still facing much economic uncertainty. Expectations have been appropriately paired back and we do not expect to see a large rebound in real yields in the immediate future.

As we expected, yield curves could not retain their steepness from the end of Q1, without some hint of rate increases which were not forthcoming from the Fed or the BoC. Much of the remaining steepness of the yield curve relates to inflation expectations which remain high. While inflation will temporarily be driven by supply/demand imbalances and underpinned by weak prices from a year ago, we do not believe a secular rise is imminent. Although we expect inflation expectations to ultimately decline, this may take some time.

Credit conditions have remained favourable given the economic rebound and continued easy financing conditions. However, cost pressures, the gradual withdrawal of monetary and fiscal stimulus, a slowing recovery, and the elevated leverage and weakened debt structures amongst lower rated credits leaves yield spreads of higher risk credits more vulnerable to widening from post credit crisis lows. In the Canadian market, which is dominated by investment grade credits, leverage metrics are similarly elevated, but debt servicing metrics are healthy and refinancing risk is not a near-term threat, even for the lowest-rated issues. The portfolio has good liquidity and is well positioned to capitalize on relative value and yield enhancement opportunities.

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[1] Note that Canada is in the dubious position to have three official core inflation measures viewed with almost equal aplomb: Core CPI – Common, Median and – Trim. The difference between the three measures are that Common is a measure of core inflation that tracks common price changes across categories in the CPI basket, Median corresponds to the price change located at the 50th percentile (in terms of the CPI basket weights) and Trim excludes CPI components whose rates of change in a given month are located in the tails of the distribution of price changes.