LORICA

Short-Term Bond

September 2021

Market Highlights

Lofty growth forecasts were paired back during the quarter due to supply disruptions and signs that inflationary pressures were weighing on consumer and business sentiment. Disappointing US employment numbers, regional delta variant outbreaks and an unexpected contraction in Q2 Canadian Real GDP (-1.1% annualized) added to concerns. The softer growth backdrop, political developments and August US CPI data, suggesting inflation pressures were peaking, resulted in benign September monetary policy decisions from both the Fed and the Bank of Canada. The Fed suggested that tapering asset purchases could end around the middle of next year, while being careful to give itself lots of latitude on the start date.

US Treasury and Government of Canada yields fell in July, traded in a narrow range through early September, rising to the end of the quarter – 5-year yields rose by 11 and 14 basis points, respectively. Both the US yield and Government of Canada short-term (1-5 yield curve) curve bear steepened with US short-term rates continuing to lag higher short-term Canadian rates. Investors have been anticipating more aggressive action from the Bank of Canada. US and Canadian overnight indexed swaps are pricing in one and two hikes in 2022, respectively.

Credit conditions remained favourable for provincial and investment grade corporate credit, but investors remained cautious, continuing to reach for yield but preferring short and mid-term issues. Provincial yield spreads benefitted from diminishing concerns over supply as provincial fiscal forecasts, which were initially based on very conservative assumptions, came in well above expectations. Domestic investment grade credit benefitted from positive corporate earnings, ratings upgrades and continued easy monetary policy. Volatility was more acute in the high yield market which saw periods of primary market disruptions. Overall, provincial and corporate short-term yield spreads tightened by 2 bps during the quarter and traded within narrow ranges.

Portfolio Activity

To capitalize on bear steepening of the provincial and corporate credit curve, the portfolio's exposure to senior domestic bank, insurance and provincial debt was increased through a reduction of shorter-term (1-2 year) issues. The duration, sector, industry and high credit quality biases were maintained.

What Worked In the Quarter

The portfolio, which had a duration that was slightly shorter than that of the benchmark, benefitted on a relative basis from the risen in yields. The portfolio benefitted from market value and duration overweights of provincial and corporate bonds, given narrower credit spreads and additional yield pickup. The provincial concentrations in Ontario and Alberta outperformed on significantly improved fiscal projections and reduced supply expectations. Overweight positions in outperforming issues of senior domestic bank, telecom and pipeline debt also benefitted performance. The portfolio also had no exposure to underperforming airport, retail, subordinated bank, utility and pension debt.

What Didn't Work In The Quarter

The portfolio had no exposure to lower-rated (BBB mid and lower) credit or issues in real estate, mortgage finance and financial services debt, which outperformed.

Outlook and Strategy

We expect economic data to remain volatile while the pandemic continues to infect the economy leading investors to act cautiously. We believe market pricing offers some opportunity for tactical positioning but expect yield curve moves to be relatively modest. It may take more time than investors think for inflation expectations to dissipate, thus placing some near-term upside risks to breakeven inflation rates and nominal yields. On the other hand, there is a risk that growth disappoints, leaving room for real yields to decline, despite already being at very low levels. Ultimately, we see near-term risk of higher nominal yields, with the potential for reversal further out.

Credit conditions have remained favourable for most industries given the economic recovery and continued easy financing conditions. However, cost pressures, loss of economic momentum, gradual withdrawal of fiscal stimulus, elevated leverage, and weakened debt structures amongst lower rated credits leave yield spreads of higher risk credits more vulnerable to widening from post credit crisis lows. In the domestic 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.

Outlook and Strategy

Consistent with the potential for higher inflation expectations and recognising that investors are not being particularly well-rewarded for investing further out the yield curve, the portfolios are positioned with slightly shorter-than-market duration, with a slight bias for yield curve steepening. Should yields rise, either through higher inflation expectations or growth surprises, we will look to take advantage of tactical opportunities. The portfolio has good liquidity and is well positioned to capitalize on relative value and yield enhancement opportunities in credit.

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