LORICA

Short-Term Bond

January 2022

Market Highlights

With inflation well above 2 percent and a strong labor market, the Committee expects it will soon be appropriate to raise the target range for the federal funds rate. Federal Reserve – January 26, 2021

Looking ahead, the Governing Council expects interest rates will need to increase, with the timing and pace of those increases guided by the Bank's commitment to achieving the 2% inflation target. Bank of Canada – January 26, 2021

Comments from the recent policy statements of the Federal Reserve and the Bank of Canada, where both banks took the opportunity of their first policy meetings of 2022 to communicate what markets had been expecting – interest rates are on their way up. Both were clear that inflation requires policy action, which would be forthcoming, likely (in our view) at their next meetings. Markets (Fed Futures and OIS) had already been pricing-in significant increases from both – about 4 and 5 hikes over the next twelve months from the Fed and BoC respectively; the number is now almost 6 for both.

Both central banks have indicated that supply-side inflation pressures are likely to dissipate by the end of the year, but it is difficult to verify their conviction around this view. The pandemic has made forecasting economic growth extremely difficult, particularly as it relates to supply side factors such as commodities, supply chains, and labour. Oil prices which had taken a momentary respite in December, surged again in January, eclipsing the highs from October. And China's lockdowns in the face of Omicron and the Beijing Olympics continued the pressure on supply chains. US and Canadian labour markets have become very tight with vacancies and openings soaring. Notably, US and Canadian unemployment rates are still above pre-pandemic levels, but the pandemic continues to play havoc with workforces (in particular, US participation rates have been slow to recover).

The large adjustments seen in equity markets has translated to credit markets, albeit only selectively. High yield has been the hardest hit – US short-term (1 to 5-year) high yield spreads widened by 70 bps over the month. Canadian investment grade credit has faired relatively well with spreads widening by an average of 10 bps, as investors took a measured response to higher yields and moderating economic growth. Noting that higher underlying government yields and the concern over equity valuations have made the reach for yield slightly more attractive. For the month, oil and gas, securitization, financial services and more defensive issues were the best performers, while lower-rated, higher beta issues were the worst.

Outlook & Strategy

It appears that Omicron's economic impact will be uneven across industries, countries, and time. However, we think that for the most part, North American economies will resume their pre-Omicron growth paths during Q1. We anticipate that supply-side inflation will be stubborn, as the factors necessary to alleviate tight supply conditions are not yet in place. That being said, bond yields have begun to rise in anticipation of central bank policy rate increases which will start this quarter. The hope is that central banks can raise policy rates slowly enough for supply pressures to abate and inflation to come down before tipping the economy into recession. Monetary policy will require a delicate balancing act from the Bank of Canada and the Federal Reserve as wage pressures are material and run the risk of embedding themselves in the economy if left to fester.

We expect bond investors to continue to cautiously "reach for yield". Credits that are higher-levered and reliant on easy financing conditions will see yield spread widening, particularly those with longer maturities where term premiums are low. We expect to see less momentum driven trade and greater differentiation of spread performance amongst lower rated, higher-beta and illiquid credits.

For the moment we are positioned for higher yields across the yield curve, but will remain vigilant for slowing economic growth, in response to more aggressive rate increases, that could drive longer term yields lower and make credit markets more vulnerable. The portfolio has good liquidity and is well positioned to capitalize on relative value and yield enhancement opportunities.

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