



# LORICA

## Short-Term Bond

September 2022

### Market Highlights

The rising trend of North American bond yields resumed in Q3 after taking a pause for the most of Q2. There was, however, a differentiation between US and Canada yields as the former rose more in relation to greater underlying economic strength. Yield curves in both Canada and the US inverted further, cementing expectations for more rate hikes and eventual economic slowdown. US Treasury yields rose, reaching new peaks from the lows established during the pandemic, across the entire yield curve. Canadian government yields also rose across the curve, but only 2-year yields reached new peaks. Short-term US and Canadian government yields are now at levels last seen in 2007, while current long-term yields are at levels last seen in 2013.

The spread between US and Canada yields widened noticeably during the quarter, reflecting expectations that rate increases by the Bank of Canada will not keep pace with those by the Federal Reserve. Currently, the market is anticipating that Fed Funds will peek at just under 5%, while the Bank of Canada's policy rate will peek at 4.25%. Both central banks went to pains during the quarter to emphasize that rates would have to stay higher for longer. The widening of US-Canadian yield spreads generated significant outperformance by the Canadian bond market in local currency terms – the FTSE Short Term Bond Index returned –0.31% for the quarter versus –2.29% for the Bloomberg US Aggregate Index and –5.46% versus –6.87% year-to-date. Notably, the Canadian bond market returned –7.2% in US dollar terms due to the significant outperformance of the US dollar against the Canadian dollar, as well as against all other currencies.

Corporate yield spreads widened marginally during the quarter, albeit with noteworthy volatility. For the moment, investors seem to be comfortable that yield spreads adequately reflect the challenging environment of higher interest rates and deteriorating economic fundamentals. However, we would note that corporate yield spreads, while close to the widest levels of early pandemic are much narrower than for previous recessions.

### Portfolio Activity

Given higher short-term government yields, wider credit spreads (short-term corporate spreads widened by an average of 8 bps) with attractive breakeven protection, exposure to two-year senior domestic bank debt was increased using excess cash. The portfolio positioning for higher yields and steepening credit curve was maintained, with a short relative duration and positions in liquid, higher-rated credits.

### What Worked In the Quarter

The portfolio benefitted from having a shorter duration (0.8 years) relative to the benchmark, given the rise in yields. The portfolio was overweight provincial credit on both duration and market value weighted bases which was positive for performance as demand for short-term high quality liquid assets resulted in the narrowing of short-term provincial credit spreads. In addition, the portfolio's provincial holdings experienced greater spread narrowing than the sector – 4 bps vs 1 bps. Similarly, the credit yield spreads of the corporate holdings were flat over the quarter, outperforming the broader market. The market overweight in provincial and corporate credit also provided additional yield for the portfolio.

### What Didn't Work In The Quarter

The portfolio was conservatively structured with concentrations of 1 to 3-year bonds in lieu of 3 to 5-year bonds which was negative for performance given the bear-flattening (greater rise in short-term yields) of the short-term yield curve.

### Outlook & Strategy

We continue to believe that investors and central banks are playing catchup with monetary policy. Throughout the tightening cycle, the persistence and transformation of inflation has been underestimated. We think that both the Fed and the Bank of Canada will be forced to continue raising rates until inflation is brought back to target. Although both banks have raised policy rates quickly to increase the speed with which tighter monetary policy will translate through the economy, policy began at very accommodative levels and amidst relatively strong economic fundamentals. It will take time for labour markets, now the major concern of inflation, to loosen, and as such, central banks, particularly the Fed, will likely continue raising rates until this happens, albeit eventually at a slower rate. Markets expect the Bank of Canada to lag the Fed as the Canadian economy appears more vulnerable to rate increases. However, we would caution that the weakening currency will have an offsetting inflationary impact to slower growth. We ultimately expect the Bank will lag the Fed, but similar to the Fed, increase rates higher than markets currently expect. We expect any increase in yields to appear across yield curves, but also expect that inversion will remain. Further out, an economic slowdown is inevitable, a recession probable.

We have maintained a shorter duration in the portfolio in the event that yields continue to be pressured higher and have reduced exposure to more vulnerable credits in the face of higher yields and the potential for a significant economic slowdown.



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