LORICA

Focused Fixed Income

December 2022

Market Highlights

After the relentless backup of bond yields that began in last Q4, we finally got some relief this Q4. Yields continued their rise through October, but the Bank of Canada's pivot to a smaller rate hike following its early December meeting was taken by both Canadian and US investors as a buying signal. Yields subsequently declined until, for what at first seemed like a positive sprint to year-end but what turned out to be, a fade in mid-December and a negative limp to New Years. Government of Canada yields finished the quarter higher than where they began – 2, 5, 10 and 30-year yields by 26, 8, 13 and 18 basis points, respectively. Corporate yields fared better, as corporate yield spreads narrowed from their widest levels at the end of October to finish the quarter averaging 10, 12 and 9 bps tighter for short, mid and longs.

The reversal in bond yields that began on December 8th also marked the peak of yield curve inversion in both Canada and the US. The spread between thirty and two-year Government of Canada bonds reached a trough of -108 bps and steepened to -78 bps by year-end. The severe reversal of the curve beyond one-year maturities represents significant investor expectation for economic slow-down and easier monetary policy. OIS markets in Canada imply that the Bank of Canada will raise rates by slightly more than one (25 bp) hike by April, but will reverse course, shortly thereafter, easing two hikes by the end of 2023. The markets are not consistent with BoC and Fed guidance, which has indicated policy will remain tighter for longer, not yet ready to declare victory over inflation, which has slowed but is still way above target.

Portfolio Activity

Given higher short-term rates and attractive relative value, exposure to short-term insurance and provincial debt was increased through a reduction in shorter-term insurance debt and excess cash.

The portfolio's short duration, flattening yield curve, sector and high credit quality biases were maintained.

What Worked in the Quarter

The portfolio was conservatively structured with a shorter duration (~2 years versus the benchmark) which was positive for performance given the rise in yields. The market overweight in provincial and corporate credit provided additional yield for the portfolio.

Performance benefited from industry and issuer composition, including overweights of outperforming pipeline, telecom, media and senior bank debt, which resulted in greater yield spread narrowing than the market (17bps versus 10bps respectively on a duration weighted basis). The portfolio had no exposure to utility, infrastructure, securitization, auto, real estate and hybrid debt which underperformed.

The portfolio was also overweight provincial credit on both a duration and market value weighted bases which benefitted performance as provincial yield spreads narrowed by an average of 3 bps.

What Didn't Work in the Quarter

The portfolio was positioned for yield curve flattening with an overweight in short and long-term debt in lieu of mid-term (7-10 year) debt – the 5-30 yield curve steepened by 5 bps during the quarter.

Outlook & Strategy

We expect investors to continue to play catchup with monetary policy. Throughout the tightening cycle, the persistence and transformation of inflation has been underestimated. Although, both the Fed and the Bank of Canada have adopted more flexible inflation targeting frameworks, we believe they will both be forced to continue raising rates until inflation is brought back close to target. While commodity and goods prices are moderating, there is still significant pressure on services. The strength of consumer demand, coupled with labour market tightness and real wage losses will likely mean further wage gains lie ahead. This will force central banks to continue to tighten policy until demand softens by slowing wage gains. But this will take time. Both banks will continue with smaller increases to reduce the eventual level of terminal policy rates, recognizing that they are likely to be forced into lengthier tightening cycles than earlier anticipated.

Overall corporate yields have risen significantly over the last year and offer attractive risk/reward opportunities. The significant inversion of the yield curve, the relative flat corporate yield spread curve, and low duration risk, make short-term corporates look particularly attractive. We are comfortable with the investment grade credits, recognising that spread volatility could still play havoc with lower rated issues, particularly in the event of a significant slowdown.

We believe that an economic slowdown is inevitable further out. We are still cautious on the bond market and prefer to maintain reduced duration exposure with a bias to yield curve inversion. We expect any increase in yields to appear across yield curves, but also expect that inversion will remain.

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