LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

This was easily one of the most volatile and stimulating months in this writers investment career. Investors were bombarded from all angles by traditional data on the one hand, and unpredictable political and economic events on the other.

Made in Canada factors were largely irrelevant, with the twin speeches from finance minister Flaherty and Bank of Canada governor Carney in mid-August being largely non-events. Perhaps, most noteworthy was the removal of rate hike speculation fuelled by the July Bank meeting and replaced with speculation of easing in the horizon.

In the U.S., the debt ceiling debacle followed by the S&P downgrade, perhaps clouded the real story which was further erosion of economic fundamentals. Steady increase in initial claims, coupled with further house price declines (Case Schiller) and weak purchasing manager reports all pointed to a weaker economic outlook. Never-the-less, from a market perspective, the polarisation of Republicans and Democrats in the house, crystalized in the minds of investors the unlikelihood of substantial further fiscal stimulus. While this was supportive for Treasuries and their Government of Canada neighbours, it was seen as bad news for risky assets, such as equities and corporate bonds, which have become accustomed to being rescued by policy-makers.

On August 9, Fed chairman Bernanke, not to be left out of the fray, sent the market a zinger with the Fed's unprecedented commitment to maintain overnight rates at the current low level (0.25%) until 2013. (Whereas a similar commitment from the Bank of Canada in April of 2009 was conditional on the outlook for inflation, the Fed was relatively silent on any conditions.) Following the announcement, the front end of the U.S. yield curve rallied frantically, dragging shorter-term Government of Canada's with it. Longer term yields were less responsive, at least initially. However, by the end of the month 10-year Government of Canada and U.S. Treasury yields had fallen by 30 and 60 basis points respectively.

The ongoing problems plaguing the Eurozone took a temporary back seat to problems in the U.S. in August. Never-the-less, noise continued to come out of Europe, generally creating a poor backdrop for sovereign debt of the fiscally-weak peripheral countries, while sideswiping European financial credits and stocks.

As noted above, risky assets while volatile were not well bid during August. The Merrill Lynch US High Yield Index (Master II) returned -4%. Investment grade corporate bonds did relatively better, with the Merrill Lynch US Corporate Master returning 0% for the month, although lagging the Merrill Lynch Treasury Master at 2.8% over the same period. Investment grade credit in Canada did relatively well returning 0.38% versus Government of Canada's at 1.76% for the same period (DEX Universe Indices)

Outlook & Strategy

The European sovereign debt crisis will continue to weigh on the global economy and global capital markets. We feel there are only three outcomes to the crisis with none representing an easy, obvious or harmless choice:

- Some sort of fiscal union, through Eurobonds or some more explicit structure – politically difficult in the pivotal German and other *core* electorates;
- Default or some other form of restructuring on underperforming debt – potentially disastrous for European banks;
- Dismantling of some or all of the Euro – no obvious process, unintended consequences are likely numerous and harmful.

We feel U.S. policy makers have run out of ammunition. There is only a remote possibility that politicians will agree to any fiscal plan of enough substance to hold hope for success, even in the short run. There is room for the Fed to undertake further non-traditional policies, but we think the only beneficiary will be capital markets, and for substantially less gains than resulted from QE2.

Earlier we had anticipated a weak global economy that would muddle along for some time. However, with the loss of confidence resulting from capital market deterioration and political quagmire, we now believe there is greater than 2/3rds probability of a recession later this year or early the next.

We have maintained a longer duration with an overweight in the 10-year part of the yield curve. We expect that short-term yields will remain anchored for some time and that gradually investors, with or without the help of the Fed, will stretch for yield further out the yield curve. We believe that the dam supporting unwanted domestic corporate bonds is starting to crack, and therefore will maintain our defensive position with higher quality shorter-term corporates.

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