



**LORICA** | INVESTMENT  
COUNSEL INC.

## Focused Fixed Income

### Market Highlights

After a steady rise from February, the bond market finally took a breather in October. With the release of some positive news coming out of the U.S. and with higher expectations for Europe, yields backed-up by 68 bps and 47 bps in the 10-year term in the U.S. and Canada respectively. However, the rally in the Treasury and Canada markets promptly resumed pushing yields to close to their lows by year-end. Returns for Government of Canada's according to the DEX Universe Index were a lofty 1.30% for December, 1.62% for Q4 and 9.43% for the year – substantial especially given historically low absolute yields.

Europe was once again a focal point during the quarter as investors withstood a series of tête-à-tête's and summits amongst European leaders. Events culminated with the establishment of the Fiscal Compact on December 9th supported unanimously by Eurozone countries, with Britain absconding and other non-zone Union members withholding consent. Unfortunately for European politicians bond investors showed their disapproval by pushing Treasury and Bund yields back down and widening Italian and Spanish yield spreads.

On the surface U.S. data was positive with housing, employment and sentiment all turning up. However, beneath the surface troubles still lurk. The improvement in housing resides mostly in rental accommodation – no help to the backlog of unsold and soon to be foreclosed homes, or to faltering house prices and the related wealth effect. While too much of the recent job gains relate to consumer activity financed through more borrowing, which in our view is not sustainable.

The corporate market finally got a boost in November as issuers took the most of the opportunity afforded by the better economic tone and issued \$13.3B in Q4 – a significant improvement from the prior quarter issuance of \$8.8B but still lagged behind levels a year ago of \$18B. Despite the placement of Ontario on credit watch by Moody's, provincial bonds managed to finish the quarter on an up note. The DEX Mid Term Provincial Index (2.56%) outperformed both the All Corporate (1.44%) and Canada (1.61%) indices.

### Portfolio Activity

Nov.: Added to position in Canada 3.25/21 and reduced weight in Canada 1.5/12 – increase in portfolio duration.

Dec.: Increased position in Canada 3.25/21 to coincide with index extensions and maintain neutral duration. Cash, coupon flow and proceeds from the redemption of 407 Intl 4.65/12 were utilized to implement the trades.

### What Worked In The Quarter

The overweight in provincial bonds versus an underweight in corporate bonds added value during the quarter as provincial's outperformed Canada's which outperformed corporates.

### What Didn't Work In The Quarter

The overweight in 10-year bonds was a negative for performance as a barbell portfolio outperformed a bullet structure during the quarter.

### Outlook

A European recession is clearly in the cards for 2012, and if anything it will be deeper than the consensus forecast. We also expect the U.S. economy to experience a shallow recession sometime in the year. Asia economies will provide some stimulus although restrained in comparison to the past.

High grade government bond yields will remain low amidst persistent volatility. Government of Canada's should be in demand – offering relatively good fiscal fundamentals and more importantly a level of diversification for global investors. We are confident that Canadian bond returns will be reasonable in 2012 – somewhere around current yields. The substantial capital gains realised in 2011 will not be on offer, but the credit markets will provide an opportunity for adding value, albeit later in the year.

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