LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Summers are supposed to be for time off and taking it easy… somebody forgot to tell the politicians! (There's always August.) In June the bond market was robbed at the 11th hour, when bonds gave up considerable ground at the end of the month, following successive votes by the Greek parliament to accept the IMF/Bundestag imposed austerity measures. In July, the bond market fought back with a vengeance, delivering the highest monthly return since December 2008 (2.04% MoM according to the DEX Universe Index), as investors moved from the *brouhaha* at Parliament House in Athens to the *brouhaha* at Capitol Hill in Washington.

As much as the news coming out of Congress was overwhelming, the news coming from down the street at the Bureau of Economic Analysis was alarming. GDP for Q2 was a surprisingly weak 1.3% QoQ annualised and even more surprisingly weak was the revision to Q1 GDP, 0.4% from 1.9% QoQ annualised. To make matters worse, the BEA also announced revisions to GDP indicating that the recession was worse and had recovered less than previously thought. It should therefore come as no surprise that as the Congress, the Senate and the President finally agreed on a debt ceiling bill (at least for now) bond investors saw no reason to sell. In fact, as at the time of writing, following the release of weak manufacturing ISM and U.S. personal spending data at the beginning of August, 10-year bond yields have fallen another 33 and 25 basis points in the U.S. and Canada respectively.

It has been interesting to observe the pontification of the Bank of Canada, as they have tried to move short yields higher without moving short yields higher. In July's monetary report, the Bank expounded upon "Headwinds, Tailwinds and the Policy Rate", explaining why the Bank's overnight rate would not necessarily have to go higher despite higher inflation, all the while confusing enough Bay Street economists, strategists and investors with a few minor adjustments to their previously released Policy Rate statement. The result was temporarily higher short term yields, perhaps dissuading some Canadian households from taking on more debt – a definite goal of the Bank's. Unfortunately, sovereign debt problems on all fronts, have forced expected interest rate hikes back out of the Canadian yield curve, leaving borrowers facing the same low yields as before the report

Outlook & Strategy

With the recent decline in government bond yields, in those countries investors deem to be relatively risk free, we expect those yields to remain low for some time. There will continue to be volatility, but yields have found a new rate structure reflecting the reality of very weak growth in the develop world, without much prospect of fiscal stimulus. We have been long and will remain so for the time being.

On the monetary front, we don't expect much from either the Fed or the Bank of Canada, with the ECB less predictable – having to balance weak peripheral economies with low German unemployment. We do not expect a resumption of quantitative easing – the Fed is too divided and the political backdrop too intimidating. The front end of the yield curve should lose some of its volatility.

Corporate bonds have proved to be resilient in Canada, despite weak equity markets and weak corporate bond markets elsewhere. Negligible issuance, yield-hungry investors and stodgy corporate traders have conspired to keep corporate yield spreads from widening significantly. We remain of the belief that Canadian corporate bond markets are still vulnerable to further underperformance.

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