November 30, 2011

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

We long ago realized the overriding influence of policy-makers on today's capital markets. After a month of hot potato, primarily played by European politicians in Berlin, Paris, Rome, Athens, and mandarins in Brussels and Frankfurt; but joined by U.S. supercomittee-men (and one woman) – eager to get in on the fun, investors can be forgiven for having tired of market-moving headlines. However, the extreme market volatility in November was also trending in the wrong direction (we believe), compelling the Fed and a cadre of Central Banks (including our own Bank of Canada) to step in, when instead of cooling the potato seemed to have gotten hotter, and catch investors off-guard. In a demonstration of finesse, and sensitivity to the markets (right at month-end no-less), or perhaps coincidence, the CB's lowered U.S. dollar funding costs to ease some of the fermenting pressures, in particular on European banks.

Closer-to-home, payroll data of late has been a bit disconcerting; October's and November's numbers were -54.0k and -18.6k respectively, adding to August's -5.5k. Although Canadian unemployment data is notoriously unreliable on a monthly basis, we don't like the anecdotal information we getting – we will be watching this number closely. On a plus sign, retail sales held up well in September and October housing starts were still healthy – above 200k.

Although equity markets finished the month on a tear, levels were slightly down from the beginning, amidst heightened volatility. The S&P 500 went from 1253 to 1247 while the S&P TSX went from 12252 to 12204 during the month. Bond yields in Canada and the U.S. did not gyrate as much, travelling in a 15 basis points range during the period, and ultimately finishing lower. U.S. and Canada 10-year yields went from 2.11% to 2.07% and 2.28% to 2.15% respectively. In the month the Barclay's Aggregate Index returned -0.09% and the DEX Universe Index returned 0.84% in local currencies, rebounding from October's weaker returns.

The new issue gate, which has been ostensibly closed, for much of the last 6 months fell slightly ajar during November, and a variety of issuers, who had been waiting like Bulls in Pamplona (for the record we are not advocates of Bull Fighting), pushed their way through. November's issuance was $6.9 Bln in contrast to the $6.4 Bln than had been issued in the prior three months. However, investors were not as eager as issuers and had to be enticed to participate with deep market concessions. Fortunately for new issue purchasers, the coordinated month-end central bank action ensured that their purchases would end the month on-side.

Outlook & Strategy

The European Crisis is still very much a Crisis in the making. There have been repeated attempts to address the issues manifesting in the sovereign bond markets of Europe, but none-of these seem to have satisfied bond investors. There is ultimately a problem of too much debt to GDP (which may soon mean insolvency) and there are few solutions to this problem:

i. Finding more investors willing to own the increasingly risky government assets does not seem like a realistic alternative given the recent rejection by SWF and the anecdotal evidence of foreign investors liquidating their positions.

ii. Growing GDP through economic growth just doesn't seem in the cards for now particularly given the austerity measures that are being put in place all over Europe.

iii. Inflating GDP through quantitative easing by the ECB is a possibility, although looking at the U.S. experience, success is far from conclusive; Germany for one is still not ready to stand behind such a policy move still fearful of inflation consequences.

iv. Increasing GDP through fiscal consolidation is perhaps the only viable alternative, but raises political questions, particularly for Germany. At this point we still believe Germany is not willing to offer its balance sheet.

All the while European politicians are tossing the potato around, Europe's credit creation has ground to a halt, nearly guaranteeing that a European recession is in the offing. Because Europe is such a large trading partner for China, it is not surprising that Chinese activity has also slowed materially. With this as the backdrop, we feel transmission to a recession in the U.S. is likely. Furthermore, the effects of Made in USA problems are simmering and we expect fiscal drag to become a greater part of the U.S. psyche.

Bond yields will continue to be volatile as long as politicians continue to make headlines – the foreseeable future. We feel only disinflation or outright deflation will take yields sustainably lower, and while that is a possibility, it is not our most likely scenario. At this time we don't see a material case for higher inflation either.

As for corporate yield spreads, we remain vigilant. We are still defensive and waiting on the sidelines for right entry point. We have been tempted into the market on more than one occasion, but prefer to wait for slower growth expectations to further widen spreads before making our move.

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