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LORICA | INVESTMENT COUNSEL INC.

# Focused Fixed Income

## Market Highlights

I very much doubt that today's version of Greek democracy is what the Greeks had in mind when they invented it some 2500 years ago. But then again it is unlikely they would have been able to envision something as unwieldy as membership in the Euro and its associated political inventions. October was yet another month dominated by the Eurozone Debt Crisis – a reality we have come to accept, and expect will not end anytime soon. Unfortunately, there are no easy decisions, and the easier ones seem to be unpalatable politically.

The risk-on/risk-off trade that investors seem to have grown numb to, was more risk-on during October. However, the Greek Premier spoiled the party at the last minute with his call for a Referendum (subsequently called off). Never-the-less equity markets finished the month up bringing YTD returns for the S&P 500 and S&P/TSX to 10.77% and 5.40% respectively. Correspondingly bonds had a significant reversal from September end, with 10-year Treasuries and Canada's finishing the month higher by 24 and 15 basis points respectively. Notably, as of writing, yields have fallen back down by 10 and 15 bps respectively.

We are off the opinion that capital markets are increasingly being driven by momentum traders responding to headlines, more political than economic in nature. It has also been interesting that investors and commentators alike have largely ignored earnings releases of late. As a result correlations within asset classes and between risky assets are at extremes. Conversely, inverse correlations between bonds and equity movements are similarly high.

Economic data has mostly deteriorated globally, with Europe showing sure signs of slowing. Even Germany, the engine of European growth has slowed as indicated by the most recent ZEW Business confidence survey. U.S. data has shown some signs of improvement with slightly improved manufacturing reports. However, we caution reading too much into recent data that has come on the back of a dividend from lower financing costs and commodity prices. In Canada, we have seen signs of slowing with deterioration in the manufacturing sector and the trade balance – we note the Bank of Canada has expressed concern over Canada's exports.

## Outlook & Strategy

Government bond yields have fallen precipitously since the beginning of the year when the outlook for the global economy was somewhat rosier. We now think yields will remain in a trading range, gyrating with the seemingly endless supply of headlines.

Of course there are risks to our view on yields, and we believe they mostly reside with inflation expectations. The hard-core monetarists still expect that the excess supply of money will eventually lead to higher inflation and higher yields. The more Keynesian view is that a slowing of demand (from weak growth) will lead to disinflation and even deflation. In terms of risk, we side with the latter. (We would also advise paying attention to the U.S. dollar which by way of being the least worse currency, not being explicitly devalued, may continue to strengthen and bring with it lower prices.)

Slower economic growth and sovereign debt problems will continue to create enough uncertainty around credit markets to frustrate an improvement in yield spreads. However we will continue to watch for any signs of change.

As for Greece and Europe, we leave you with the words of Country singer Sunny Seeney …

***"Staying's Worse Than Leaving"***

Leaving's hard…trust me, it's really bad
It'll shake ya, damn-near break ya, it always has
You don't go until you're praying to break even,
Until staying's worse than leaving

God knows we tried everything that we could do
You can keep your pride and blame me if you need to
Even though this freedom feels a lot like treason,
I know staying's worse than leaving

It's gotta get better, it can't get worse
Hope it's a blessing not a curse
I don't care who passes judgement on my reasons
I know staying's worse than leaving ….

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