LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The deterioration of economic indicators in the U.S. continued in earnest in May culminating with a shockingly-weak non-farm payrolls report. For the month the U.S. labour market only managed to add 54k new jobs, well below the consensus forecast of 165k, and more importantly well below the 300k+ needed to both absorb new entrants to the labour force and make a dent in the unemployment rate. Not surprisingly, the unemployment rate ticked up slightly to 9.1% (15.8% for U6, which includes underemployed workers).

The labour report was just the tip of the climate-changing iceberg that showed a global economy facing many challenges. While, there is no shortage of optimists who, point to supply-chain disruptions emanating from Japan, inflated energy prices, and the impact of freakish weather as the root of much of the slowdown, we are not prepared to accept that the widespread nature of the weakness is so narrowly based.

With austerity packages in place in countries in the Eurozone periphery, tighter monetary policies in developing economies such as China and Brazil, and stimulus fiscal policies under pressure elsewhere, it is not surprising that investors are looking past the short–term aberrations and revising their capital market forecasts.

Taking the lead from the U.S. Treasury market, yields fell in all major bond markets across the globe with the exception of peripheral Eurozone, where the problems plaguing state finances continue to take a toll on bond yields. Most developed countries Government bonds returned over 1% in local currency terms for the month. Of course the strong performance of the U.S. dollar during May (3.1% vs. the Euro and 2.5% vs. the Cad) resulted in significantly better returns for Treasuries in U.S. dollar terms.

For most of the period corporate bonds were impervious to the goings on in elsewhere as investor demand for yield continued to be a theme supporting riskier assets. However, the 1-2 combination of European sovereign debt problems and worrisome global growth proved too much for corporate yield spreads towards month-end, causing credit spreads to widen. In Canada short, mid and long corporate yield spreads widened in May by 2, 5 and 3 basis points respectively.

Never-the-less the Canadian corporate bond market returned a healthy 2.29% for May as compared to 2.85% for provincials (somewhat overstated by the longer provincial duration) and 2.29% for Government of Canada's, all according to the DEX Universe Index.

Outlook & Strategy

We expect weak U.S. GDP in the second half of 2011 and a Canadian economy that will not be as resilient as in the last few years. The strong housing market of the past is unlikely to provide the same offset this year. Inflation will remain a commodity problem with relatively high unemployment preventing wholesale transmission to the broader economy.

A divided Fed will ensure an end to quantitative easing in the summer; but we don't expect rate hikes this year. We are non-consensus with our view on the Bank of Canada (admittedly consensus has moved closer to our position) – no tightening until Q4 at the earliest.

Bond yields will surprise many with their stubbornness to stay low, while the steepness of the yield curve offers an opportunity to pick-up yield.

Finally, we are more cautious than most over the prospects for risk assets including equities and corporate debt. Downward revisions for growth and sovereign debt problems will challenge investor risk tolerance.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com