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LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Although market troubles in late July suggested difficulties for riskier assets may be in store for August, Central Bankers, who were quick to respond with soothing rhetoric, managed to convince investors to overlook their fears. Consequently risky assets responded with healthy rallies, as U.S. equity levels pushed towards multi-year highs (S&P: 1407, DOW: 13091 and NASDAQ : 3067)and corporate bonds substantially outperformed governments. In Canada the DEX Mid Term Corporates returned 0.48% versus Governments at -0.23%. Although, the prospects for imminent economic rebound in Europe and the U.S. are slim investors have become reliant on central bank stimulus to propel valuations of risky assets.

It is no doubt an interesting time in economic history, where the fate of a substantial portion of the global economy (Europe and the U.S.) has been largely delegated to the machinations of appointed central bankers, while elected officials largely sit on the sidelines, unable and unwilling to undertake effective new policies. As we go to press, the ECB has initiated another program of bond buying, while the Fed has indicated more non-traditional monetary policy is on the horizon. For what it is worth, Chinese policy making, still originates with the government by default (there is no discernible distinction between the central bank and the government.), however, Chinese authorities have indicated they are likely to take a more moderate approach to further stimulus.

Although the Canadian economy has largely been spared the travails of Europe and the U.S., some of the key areas of strength have begun to show signs of slowing. Construction, which has been at the heart of Canada's recovery, is contracting as the housing sector, particularly the buoyant condo market, begins to show signs of retreat. Also, retail sales have declined noticeably as consumers feel the weight of debt burdens and weaker job growth, and shoppers get lured south of the border, in response to the strong C$. The economies of Alberta and Saskatchewan continue to outperform the rest of the country, having benefitted from an improvement in energy prices and lower levels of unemployment.

Outlook

For now we expect the bond buying program of the ECB to keep a bid on risky assets including corporate bonds. However, the challenging economic backdrop and the prospects for further Fed action will simultaneously keep a lid on bond yields. As for the Fed, it finds itself in a difficult spot, willing to undertake more easing (quantitative or otherwise) while mindful of the intensifying election contest. Note the GOP's general distaste for further monetary easing. While, there is still a window to act before the election, it is getting narrower – the recent employment numbers do provide some impetus.

Bond yields will stay low but will continue to experience volatility as investors respond to each policy motion or commotion. And while drought conditions and Middle East unrest have driven up the cost of some commodities, we don't think inflation expectations will be a factor. Yes, there is lots of liquidity in the monetary system, but nothing that should be of concern with such high unemployment rates. U.S. monetary policy is supportive of low yields, and if anything we think the Bank of Canada should be biased lower. We will continue to look for trading opportunities to capitalize on changes to the shape and level of the yield curve.

Increased volatility and event risk present an opportunity to capitalize on relative value and yield enhancement. We however feel that investors are increasingly becoming complacent on a risk/reward basis in their reach for yield and that a certain level of caution is still warranted as significant headwinds both in respect to the European sovereign crisis and North American economy remain.

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