



**LORICA** | INVESTMENT  
COUNSEL INC.

## Focused Fixed Income

### Market Highlights

Politics and policies were again the focus in Q4, as investors took their cue from events that transpired in the U.S. Although candidate Romney made the U.S. election less competitive than what could have been, investors watched closely as the divide between Democrat and Republican philosophies and policies made any outcome that much more consequential. With Democrats winning the presidency and the senate and the Republicans retaining control of the House, tense Fiscal Cliff negotiations were inevitable – although no-one could have predicted such a hollow *twelfth-hour* agreement. The can has been kicked down the road *again*, and the impetus for constructive collaboration to tackle the U.S. growth and debt problems appears further out of reach. Not to be completely outdone, the Fed grabbed some headlines by a re-work of their forward guidance tools by replacing the calendar date guidance with thresholds for inflation (2.5%) and unemployment (6.5%).

Europe's schizophrenia saw a momentary hiatus as markets became more convinced that ECB President Draghi could in fact solve the Euro debt sickness China was embroiled in a government transition of its own that took focus away from the weak economic data that had been portending a slowdown – although recent data suggests a well-timed bounce for the new legislature. Japanese elections would normally not garner much attention, but the new Prime Minister Abe appears determined to introduce further monetary stimulus and promote a weaker yen. By global standards, Canadian events were relatively boring with the highlight being superstar Bank Governor Carney's announcement of his departure for the Bank of England and subsequent leak of his ill-timed family vacation at the summer home of the Liberal finance critic.

As for investors, the safe bet has been to stick with the Fed. It has become increasingly difficult to extrapolate economic and market data beyond the next policy move. However, for equity and credit markets, interest rate repression by central banks has been more than supportive. For government bonds the environment has been complicated – investors have had to weigh the support from quantitative easing against the buildup of liquidity. The DEX Universe Index returned 0.30% for the quarter, resulting in a return of 3.60% for the year. In sector terms, corporates and governments returned 0.80% and 0.11% for the quarter, and 6.22% and 2.65% for the year respectively.

### Portfolio Activity

Early in the quarter, bank subordinated debt came under pressure due to expectations that a number of banks would take the opportunity to pad their Tier 2 capital levels before 2013, after which only non-viability contingent capital sub debt could be sold.

On the back of the widening, the maturity of our Bank of Nova Scotia holdings was extended from 2013 to 2019.

Provincials remained attractive on a risk-reward basis and a purchase of New Brunswick 3.35/21 was made. The trade also tactically boosted the portfolio's exposure to the belly of the curve and increased overall duration.

### What Worked In The Quarter

The portfolio was overweight corporates relative to the index, concentrated in higher yielding and higher beta short and mid-term financial and telecom/cable issues - both top performers.

A long position was also held in provincials, where spreads tightened on average only a basis point during the quarter. However, the portfolio was concentrated in Ontario, Nova Scotia and New Brunswick issues which tightened by 3-5 bps in the mid-term area of the yield curve; and Quebec, which outperformed all other provinces in the long end.

### What Didn't Work In The Quarter

For the quarter, short, mid and long-term yields rose by 8, 7 and 5 basis points respectively. On a duration adjusted basis, the portfolio was underweight long-term bonds

### Outlook

Canadian government and monetary policy is not facing the kind of pressures seen elsewhere, making it easier to extrapolate economic data. Our expectation for the BoC's next move is down. However, whatever happens in the U.S. will still have a profound impact on Canada's economy. As events of the last fortnight have demonstrated, the U.S. government is polarized and outcomes intractable and unpredictable. Damage has been done to consumer confidence and business investment, and we anticipate further negative economic impact from fiscal restraint. Bond yields have suffered in the short run, but we are more likely near the top of a trading range.

The appetite for risky assets sees no bound, as long as there is such a large tailwind from central bankers. Going long the corporate bond market has become a very crowded trade and one has to wonder if there is much room left at the top, and what the size of the escape hatch is, given the sectors liquidity. We are confident that there is more easing to come from, but there is also room for corporate deterioration on the back of weak earnings. The biggest light is shining from the housing market and policy-makers are doing everything in their power to keep it lit. We are paying attention, but at this point are not convinced that housing can generate the kind of employment growth necessary to offset problems elsewhere.

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