LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Volatility was king in April as the markets responded variedly to a mix of macro and company specific data. The Euro-zone's sovereign debt problems, which had been lurking in the background since the first LTRO (Long Term Refinancing Operation) launch last December, resurfaced with renewed zeal as Spain entered the spotlight as the next casualty in the European version of hot potato. For the risk-on crowd, Apple's blockbuster earnings were the catalyst to reverse the selling that had gathered steam in the first half of the month. (The S&P took a round trip during the month – hitting a high on the2nd of 1422 and low on the 10th of 1357, while ending the month back at 1398. The VIX – S&P volatility index – peaked at over 20, after hovering around 15 for most of March.) In general, there was something for everyone – weaker U.S. employment data was suggestive of a replay of last year's spring slowdown, while an uptick in U.S. building permits and mortgage applications raised hopes of a bottoming of the housing market.

However enthusiastic the risk-on crowd (which includes credit investors) was, this sentiment was not shared by the rates crowd. Bond yields which had steadily risen throughout the first quarter, fell alongside equity prices in the first half of April, but did not rise in sync with the equity rebound in the second half. In fact 10-year U.S. bond yields ended the month 30 basis points below their starting point of 2.21% at the beginning of the month, and just above the 1.88% seen at the beginning of the year. We believe there is a disconnection between the government bond market and equity markets, which we believe is not sustainable. There have been some suggestions that equity investors remain hopeful of further quantitative easing (or something of the sort) to justify their valuations, while bond investors are responding to the string of poor economic and sovereign debt news received during the month.

Our interpretation of Bernanke's Fed's position on monetary policy is that continued weak employment data will lead to more active monetary policy. However, given the dissonance amongst Fed committee members, the threshold for action appears relatively high to us. Keep in mind that under Bernanke, the Fed has instigated more transparency in its communication, which has ironically caused more confusion as to what the future direction of policy is. More transparency has meant more voices and hence more viewpoints, not always in agreement.

The Bank of Canada also did its part to instill some confusion relating to the course of monetary policy (as if uncertainty around the Fed was not enough for Canadian investors). The Bank's April key policy rate announcement and monetary policy report both hinted at a likelier tightening of monetary policy this year. Our take on the Bank's position, is that Governor Carney is uncomfortable with consumer debt levels, and by association the housing market, and is therefore using his platform to influence consumer behaviour. We are skeptical that actual economic data will provoke a rate increase this year, especially given the hugely disappointing Q1 GDP data and our expectations for the U.S. economy.

The actions of the ECB are more difficult to predict. To begin with the ECB's policies are far more influenced by political interference than those of other advanced central banks. Secondly, the vastly different fiscal dynamics that Eurozone members find themselves in means that one monetary policy does not suit all. (This has been an ongoing problem for the zone, and without some sort of fiscal harmonisation, is destined to continue.) Germany's economy is still firing on all cylinders –unemployment has reached a 20-year low, while the periphery is getting bigger and falling into recession. Like the Fed, the bar at the ECB will be kept high (by Germany), but we expect further zone problems to force the ECB to intervene with more liquidity measures. The recent decline in German CPI does, however create the backdrop for further reductions to ECB policy rates.

Outlook

As we mentioned earlier, we don't believe the equity markets are in alignment with the government bond markets. We feel that the government bond markets have discounted the recent economic data, and have subsequently reduced expectations for growth and inflation this year. Investors have also begun to temper their optimism for the Eurozone. However, we have not seen a similar move by the risk-off crowd, which we anticipate in the next couple of quarters. This will also impact corporate yield spreads that narrowed aggressively in Q1, but have similarly not widened with the recent decline in government yields.

We are cognizant of the fact that market participants are generally pointing the same way in the credit markets, and hence will exacerbate spread moves in either direction. We will continue to look for opportunities to increase the yield of the portfolio and take advantage of movement in spreads.

For now, we expect the Fed to maintain low short term rates and the rest of the yield curve to follow suit. (Keep in mind that when the Fed does decide to remove stimulus, it will likely not be first by raising interest rates, but rather by effecting policy to drain reserves.) There may be another round of quantitative easing (of sorts), which would likely push longer-term yields lower, if anything. The market volatility that we have seen recently should be expected and we will use it as an opportunity to position the portfolio to take advantage of temporary changes to the yield curve.