February 29, 2012

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Bond market activity in February was dominated by corporate bond issuance and investors new-found (however fleeting) willingness to add those bond issues to their already bloated corporate bond positions. Corporate issuance totalled a February record of $Cdn 8.4 bln to supplant January's record of $Cdn 7.4 bln. Furthermore, the good tone in the equity and credit markets combined with the relatively juicy new-issue yield spreads convinced investors to take down even the most heretofore troublesome sectors. Insurers and Maples (Canadian $ foreign issuer) each accounted for about $Cdn 1.3 bln in new bonds. (Please see our Focused Corporate Bond commentary for more details.) For the month corporate yield spreads narrowed by 11 basis points resulting in corporate returns that exceeded government of Canada's by 1.1% (according to the DEX Mid Term Bond Index).

Yield levels moved marginally higher during the month with 5 and 30-year yields both rising by 14 basis points, underperforming the belly of the yield curve where 7 and 10-year yields rose only 11 and 10 bps respectively. The portfolio's concentration in 10-year bonds added to performance both from the move in the yield curve during the month, as well as the additional yield pickup from optimal placement along the yield curve. The Canadian and U.S. yield curves continue to exhibit little directionality, being somewhat constrained by the Fed's transparent forward looking communication at the end of January.

It has not taken much to buoy the equity and credit markets this year, just some hint of positive movement in the underlying data. Hence, improvement in non-farm payrolls to 243,000 for January (and 203,000 for December) from the 6-month average of 123,000 to November has been enough to get the markets humming. There has also been improvement in the ISM data – particular on the non-manufacturing side. But in general, the data has been mixed, particularly the more recent numbers such as durable goods orders and personal income and spending.

Our observations of recent credit markets suggest to us that the general deterioration in market liquidity has had a non-symmetrical impact on prices, albeit consistent with what conventional theory on loss aversion would predict. As liquidity in the credit markets has recently improved (although nowhere near levels before the credit crisis) following more optimistic outlooks for the economy and subsequently credit, we have watched yield spreads and prices improve in dramatic fashion. However, prior episodes of pessimism, notably in the fall, have been met with rapid disappearance of market liquidity, but only gradual decline in spreads and prices. Theory on loss aversion suggests that investors are more reluctant to take losses than gains which would imply that in today's volatile credit markets prices are adjusting more rapidly on the way up than the way down.

Finally, the ongoing saga of Greece and the Eurozone continued in February, with a march forward, but to where we are unsure. Eurozone growth is troubling (albeit to Sarkozy and Merkel is set to improve on the back of Europe's Fiscal Compact?), with the QoQ GDP for Q4 turning negative (-0.3%). Although both Portugal and Spain announced budget updates to be below what is necessary to meet their Eurozone commitments, investor reaction was relatively muted.

Outlook

Government bond yields will remain at low levels for the foreseeable future. Although there are signs of economic improvement in the U.S. and U.S. fiscal policy has not yet been the drag that it could have been, the Fed's commitment to lower rates will also put a ceiling on longer term bond yields. Canadian bonds may further benefit from a weaker Canadian outlook for growth; although we do not expect the Bank of Canada to lower short term rates, and hence are not expecting a steeper yield curve. We will continue to look for opportunities to position the portfolio to take advantage of yield volatility.

Despite the recent (and not entirely unexpected) uptick in tolerance for risk displayed by the credit markets, a certain level of caution towards credit is still warranted. Recent economic data has buoyed optimism yet significant hurdles both in respect to the European sovereign crisis and North American economy remain. The corporate bond market will continue to be impacted more so by exogenous events and supply, than company fundamentals. However, we feel the potential for increased volatility and event risk presents an opportunity to capitalize on relative value and yield enhancement.