January 31, 2012

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

January's overall better-than-expected U.S. economic data, accompanied by a generally supportive policy backdrop globally, provided investors with some much-needed psychological relief. The risk-on proponents got the better of the markets, with equities rallying substantially (S&P 500: 4.36% and S&P/TSX: 4.16% - local currency) and riskier corporate bonds outperforming their safer government credits, during the month. DEX Universe corporate bonds returned a healthy 1% compared with provincials at 0.42% and federals at 0.26%. Despite the favourable environment for riskier assets, government bond yields did not rise, with 10-year government of Canada's managing to fall from their extremely low yields by 5 basis points. Overall bond market returns were still a decent 0.51% for the month.

Although there has been improvement in the U.S. economy – most notably employment has taken on a better tone; there are still underlying problems which have not convincingly disappeared. Despite the increase in non-farm payrolls (averaging 201,000 for the last three months), participation in the labour force has declined and wages have remained stagnant. The housing sector has also shown some recovery and investors have displayed their enthusiasm by buying cheap housing stocks (S&P 500 Homebuilding index returned 11.88% in January), but there is still a backlog of foreclosures likely in 2012. Finally, there has been noticeable improvement in manufacturing activity, but we have also seen a commensurate buildup in inventories (U.S. real private inventories increased 2% qoq).

Policy continued to be a dominant factor influencing markets in January. The European situation remains fluid, while arguably showing some signs of progress during January – the Fiscal Compact (we are not convinced of its relevance) was agreed to by members of the Eurozone. However, the Greek situation made only marginal advances leaving resolution to another day. The most significant action came from the Fed and Bernanke's mission of transparency – the latest action was release of FOMC member anonymous policy rate forecasts. While there was no mistaking the overall direction of the Fed – low rates in place until 2014, we think that publishing specific forecasts may only create more confusion and doubt amongst investors.

In Canada, January's data point to tougher times ahead. Employment data continued on its weak pace from the summer, bringing the six month average to a miniscule 2.8 thousand new jobs. January's trade balance continues to be impacted by weaker commodity prices although netting slightly positive in January ($1 Billion). And finally, consumer debt fundamentals showed little improvement with debt to household income ratios sitting at historically high levels (around 150%). Officials from both government and the Bank of Canada appeared to be treading a fine line – worried about excessive consumer debt but reliant on consumer leverage for domestic growth. In the BoC's January Monetary Policy Report, housing is expected to make a major contribution to overall growth in 2012 (0.3%).

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 fundamentals. However, we feel the potential for increased volatility and event risk presents an opportunity to capitalize on relative value and yield enhancement.

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