LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Credit markets were not to be left out of the first quarter risk-on party, and consequently outperformed their government counterparts. The DEX Universe corporate indices returned 0.97%, 1.42%, and 2.04% for AA, A and BBB bonds respectively. Conversely DEX mid-term yield spreads (a more representative measure that eliminates duration differences between credit tiers) narrowed by 25, 42 and 33 for AA, A and BBB bonds respectively.

The demand for credit emerged slowly, but when it hit, it hit hard, causing yield spreads to narrow rapidly. Feeding into typical first quarter demand, issuers fuelled the rally by launching new issues at concessions that were large enough to maintain investor support. (Remember issuers apparently don't mind leaving something on the table for their supporters, when they can lock in historically low all-in yields.) The issuance party was relatively short-lived, all but drying up by March.

Policy-makers were supportive of the *risk-on* trade, and we highlight the central banks in this regard. The most important catalyst was the ECB who through two rounds of long term refinancing operations (LTRO), has managed to remove the threat of a European banking crisis and credit contagion, and consequently create a more attractive environment for riskier investments. However, in the process the ECB has increased its reserves by around 50% from this time last year, and locked in relatively long-term commitments in exchange for questionable collateral.

As for the economic data in the quarter, investors have resumed focusing on employment data, which has not disappointed. U.S. non-farm payrolls have averaged 245,000 net new jobs for the last three months, and the employment rate has dropped to 8.3%. The recovery-doubters point to the extreme warm weather as the key factor behind the improved numbers. We note that manufacturing has disproportionately accounted for job gains and wonder if this trend can continue or lead to gains elsewhere, next quarter. The Canadian jobs picture has taken a dramatic reversal with March's blockbuster numbers, but as usual this only highlights the inadequacy of Canada's job reports.

Portfolio Activity

Sold positions in Manulife Cap Trust 6.7/12 and Canada 1.5/12 and established position in Canada 2.0/12. Overall duration marginally increased.

Purchased BNS 2.598/17 and reduced holding in Can 3.75/19 and Can 2.0/12. BNS issue provided attractive relative value.

Reduced overweight in the belly of the curve through a butterfly trade. Can 4.0/41 and Can 2.0/14 were purchased and Can 3.75/19 and Can 3.25/21 were sold. With the backup in yields, an overweight in the 10 year area was re-established via the sale of Can 4.0/41 and Can 2.0/14 and purchase of Can 2.75/22. The duration of the portfolio was extended by ¼ years.

What Worked In The Quarter

The overweight in the 10-year part of the yield curve during January and February added value as 10-year yields outperformed 2 and 30-year yields by 11 bps and 7 bps respectively over the period. The butterfly trade and reversal (above) also added to performance towards the end of the quarter.

What Didn't Work In The Quarter

Our more defensive position vis-à-vis corporate credit was a negative for performance as corporate yield spreads narrowed significantly during the quarter.

Outlook

We don't expect widespread credit concerns to re-emerge in the near-term, as we accept that central bankers have gained control of the current environment. However, we anticipate general economic data will disappoint. Further out, the problem of massive sovereign debts and high unemployment, particularly amongst youth, will likely impact markets.

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.) 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.

We also expect some volatility in credit spreads, but any widening should be constrained as the threat of crisis and contagion has been removed for the time being. 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 movements in spreads.

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