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LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The bond market rally marches on… Higher quality sovereign bond yields, after initially rising in Q1, have fallen in dramatic fashion in May, with 10-year yields sinking to levels never seen before. American, Canadian, British, Australian, German and other central and northern European 10-year yields all hit all-time lows in May. Japanese yields have also fallen, but are still above the levels of May 2003. For most countries, this has meant a continuation of the bond rally which began in September of 1981. At that time, 10-year treasuries and Government of Canada bonds peaked at 15.8% and 18.1% respectively. May's local currency return was 2.11% for the Canadian bond market (DEX Universe) and 2.33% for the U.S. bond market (Barclays Capital U.S. Aggregate).

While, for much of the three decade decline in bond yields, corporations benefitted from a decline in funding costs which, along with lower discount rates, translated into higher equity prices, the same cannot be said today. For the last three years, as bond yields have consistently fallen, equity prices have rallied only to be subsequently knocked back, showing little reward for the bangs and bruises endured along the way. To May, the S&P 500 and S&P/TSX have returned 4.19% and -3.70% (and still falling) respectively, after having been up 12.00% and 3.70% respectively at the end of the first quarter.

During May, the dual themes of European sovereign debt and U.S. economic recovery once again erupted in a big way; and while many investors are still on the sidelines, there are enough traders to push the markets around. Although the troubles and responses in Europe and the U.S. appear quite distinct, the common threads of too much government debt and too little employment growth will continue to strangle these economies over the medium term.

As in the last few years, investors as well as the economy have responded on cue to the various central bank and government stimulus. Riskier assets, which includes corporate bonds, and their investors have benefitted, albeit in the context of substantial volatility. Traders have been even bigger beneficiaries, provided they have been nimble enough to get ahead of the market moves. Take the corporate market for example: yield spreads narrowed quickly in Q1 as investors chased new issues, and have similarly widened quickly thus far in Q2. The sell-off has been also met with a reasonable amount of new issuance as issuers have sought to capitalise on the low all-in financing costs, resulting from the low yields. Investors, despite wider spreads, have had no difficulty absorbing the new issuance given their substantial caches of cash.

Outlook

We believe that debt and equity markets have now discounted the recent economic data and European sovereign debt news. While we are inching closer to the make-or-break time for Europe, we still believe there is room for more stop-gap measures, and expect only a stop-gap measure in the near future. However, with each additional manoeuver the market appears more sanguine; we anticipate the same this time.

In our minds, Bernanke has shown his predisposition to more non-traditional monetary policy stimulus, should the circumstances require it. We think the circumstances will require it, and this will become more evident over the next few months. Complicating matters is the little issue of a Presidential election in November which should impact the timing of any Fed action – therefore look for a move in the summer. Given the recent rally in mid and long-term yields, we think the preference will be for some action that targets credit spreads, perhaps mortgage securities.

After the Bank of Canada's April MPR and policy announcement, there were many commentators and analysts who felt that the Bank was signaling a policy move by as early as mid-year. Investors responded by pricing in several hikes to take place by year-end. Macro events and data have subsequently resulted in the hikes being priced-out. Our take was that the Bank was more likely trying to inhibit further consumer debt growth through stealth communication rather than by taking any real action. In any event, we expect the Bank to remain safely on the sidelines.

We continue to look for opportunities to add yield to the portfolio and take advantage of market volatility.

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