LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

U.S. Treasury yields continued their relentless march lower, followed closely by government of Canada yields. In both markets, 10-year benchmarks fell to new all-time lows (U.S. – 1.40% and Canada – 1.57%), as investors continued their exodus out of more risky assets, and headed for safe haven currencies and their bonds. The Bund market, the easiest destination for investors fleeing the peripheral European sovereign markets of Spain and Italy, benefitted enormously with 10-year Bund yields reaching an all-time low of 1.17%. Japanese yields (10-year yields dropped to 0.72%) are no longer considered extraordinary, as the longer term outlooks for developed countries converge. Although the European sovereign debt crisis was the dominant news story, the disappointing weakness of U.S. data added fuel to the bond rally.

Risk assets were down for much of the month, but as has so often been the case over the last few years, policymakers stepped in, propping up markets with the assurance of some form of intervention. It was ECB president Mario Draghi's turn this time, and he was apparently up to the task as he pledged that the ECB "is ready to do whatever it takes to preserve the Euro." Although investors do not have any concrete plans from the ECB, and the Bundesbank has indicated they are not in support of further ECB bond purchases, Spanish yields did manage to fall below the much feared 7% level on the back of Draghi's comments.

The Canadian corporate bond market has been noteworthy for its resilience to yield spread widening. During the month, U.S. corporate yield spreads were volatile, but finished narrower – the CDX IG 17's (5-year investment grade CDS index yield spread – a good indicator of corporate spread movement in the U.S.) moved within a 11 bps range, ending up 5 basis points narrower than at the start of the month. By contrast Canadian corporate yield spreads narrowed consistently ending the month 9 basis points tighter according to the DEX Mid Term indices. Demand for Canadian corporates has been high due to the high level of domestic bond and corporate bond fund flows, cross-over equity and foreign investor demand, and well-priced new bond issuance.

Outlook

Unfortunately for investors, the markets are going through the same kinds of gyrations that we saw last year and the year before. Policymakers, whether from the Eurozone or the U.S. are being forced to confront the issues, but as before are only doing so in superficial ways that merely gloss over the problems and push real resolution further out into the future. We think there is still further road to *kick the can down* in Europe, but we are getting closer to the end. In the U.S. there is plenty more room with which to ignore the fiscal and monetary problems, and so we don't expect any significant changes just yet. We don't think anticipation of a fiscal cliff will be a catalyst for real solutions, and we expect the fiscal cliff to be avoided. Consequently, we don't expect policy changes will significantly impact the path of growth or the markets in the short to medium term.

Bond yields will stay low but may experience volatility as investors respond to each policy motion or commotion. And while drought conditions may have driven up the cost of some commodities, we don't think inflation expectations will be a factor. Yes, there is also lots of liquidity in the monetary system, but nothing that should be of concern with such high unemployment rates. U.S. monetary policy is supportive of low yields, and if anything we think the Bank of Canada should be biased lower. We will continue to look for trading opportunities to capitalize on changes to the shape and level of the yield curve.

Increased volatility and event risk present an opportunity to capitalize on relative value and yield enhancement. We however feel that investors are increasingly becoming complacent on a risk/reward basis in their reach for yield, and that a certain level of caution is still warranted as significant headwinds both in respect to the European sovereign crisis and North American economy remain.

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