LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Since Fed Chairman Ben Bernanke's QE3 announcement and ECB President Mario Draghi's pledge to buy unlimited amounts of troubled Eurozone debt (both made in September), capital markets have responded with predictable optimism. Measured in terms of returns on risky assets, monetary authorities have been able to claim success; however, economic success still remains elusive. It has not been surprising that central bankers have been forced to the forefront of policy initiatives, given the tail risks to the economy and markets from the potential fiscal cliff and Euro disintegration. At a time when the U.S. government has been pre-occupied with the presidential election and Eurozone governments are suffering from austerity fatigue and general dysfunction. Equities and bonds, particularly corporates and peripheral European sovereigns, have benefitted significantly from the monetary policy moves.

In October, corporate bonds globally continued their outperformance of government bonds, despite the backdrop of weaker corporate earnings and generally unfavourable economic news across the globe. The Canadian corporate bond market was no exception, as October was yet another month that saw corporate bonds carry favour with a broad range of investors. And issuers were happy to join in the mix, continuing the pace that was set in the first three quarters of the year. October corporate new issues amounted to $9.5 billion, bringing the year's total to $52 billion, on track to surpass the record new issue total of $65 billion set in 2010.

Anecdotally, there was broad demand from retail investors who funnelled money into fixed income and more specifically corporate bond funds, as well as through equity portfolios that have crossed-over into the corporate bond market. Canadian investors have long had far less global diversification in their fixed income portfolios than their American counterparts, and the move in recent years by investors to increase their exposure to corporate bonds has exaggerated the relative demand for Canadian corporate issues. While underwriters have responded with more corporate issuance, the supply has not kept pace with the demand. In the investment grade market, new issues launched during the month were all well over-subscribed, with the supply-demand imbalance being particularly acute for non-financial issues.

As for government bond markets, yields on Government of Canada's and Treasuries were only slightly higher during October as investors were largely on the sidelines in anticipation of the U.S. election. (The DEX Universe Canada Index yield was 1.52% versus 1.49% the month before.) We believe the fiscal cliff looms large in investor's psyches, and the outcome of the election is significant in that regard. With the Obama victory it remains to be seen whether the President, the Senate and Congress will be able to come up with a credible agreement on the debt ceiling and the budget. In the early going following the election, markets have been volatile, and will likely continue to be so until the picture becomes clearer.

Outlook

We don't expect the U.S. to fall off the fiscal cliff just yet. Although the parties involved will find it difficult to put in place a long term solution, we anticipate some kind of short term Band-Aid will be applied. Bond investors should be prepared for more market volatility, but ultimately will not see a materially different environment unfold. If the markets do get too unwieldy, it is conceivable that the Fed will provide further stimulus. We will use the uncertainty as an opportunity to add value.

In Canada, we expect to see continued deterioration of the economic fundamentals. While most of the developed world has struggled since the Credit Crisis, the Canadian economy has succeeded on the back of consumer consumption and government spending – two areas that cannot be counted on going forward. Although the Bank of Canada has delayed further tightening for a variety of reasons, investors are still convinced that the banks next move is up. (According to overnight indexed swap rates, only a negligible amount of investors expect the overnight rate to be lower one year out.) We believe that investor sentiment will change resulting in a higher probability of a rate decrease by the bank – a move not currently factored into the market.

Finally, the corporate bond market will continue to be impacted more so by exogenous events and supply than corporate fundamentals which in terms of leverage, liquidity and profitability remain sound. In the near term, while we do not expect any significant degradation in the general quality of credit or any significant deviation from conservative corporate policies, we do feel credit ratings may come under pressure. We will continue to look for relative value opportunities and in the sector.

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