LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Q3 turned out to be a surprisingly strong *risk-on* quarter despite the rather poor prospects for many of the world's largest economies. From a bond perspective, government yields were not much of a story – U.S. and Canadian yield curves rose by as much as 64 and 42 basis points (respectively) during the quarter, only to fall by quarter-end to average -4 and +3 bps (respectively) from the start of the quarter. Credit markets were another story, however, as investors embraced the enhanced income of corporate bonds, encouraged by credit-friendly central bank policies and continued skepticism surrounding equity markets. In Canada, corporate yield spreads finished the quarter 26 basis points narrower, according to the DEX Universe Mid Term Index.

The U.S. economic outlook was not much improved, albeit for the housing market which appears to have finally hit bottom. The dearth of new stock and stalled foreclosure process have helped stabilise prices, however when combined with tight lending standards and weak economic prospects, have also constrained overall activity. Europe's ongoing sovereign debt crisis continued to grab headlines in the quarter, although most investors seem convinced, at least for the time being, that the ECB is up to the job of clearing the major obstacles. Spain has taken over from Greece as the problem child on the back of a crippling debt situation and high unemployment, and Spanish bond yields have thus remained elevated.

The Canadian economy presents a more troubling picture; housing is showing signs of fatigue – stricter mortgage lending standards and decreased affordability have slowed building intentions, particularly in the condominium segment. Canadian manufacturing is still struggling on the back of a definitively stronger C$. Commodities present somewhat of a mixed bag – oil prices, which have garnered an increased share of exports, have been firm, while prices for other sectors such as natural gas and metals have been weak.

Portfolio Activity

The portfolio was optimally structured on a yield curve and sector basis thus trading was limited. The holding in Can 2.75/22 was tactically increased to boost the portfolio's exposure to the belly of the curve and increase overall duration.

What Worked In The Quarter

The portfolio was long both corporate and provincial credit relative to the index. Provincial spreads tightened on average by 7 bps during the quarter with the over-weighted Ontario and Nova Scotia issues outperforming. The corporate exposure was concentrated in higher yielding, higher beta short and mid-term financial and telecom/cable issues, which were top performers.

The portfolio has a concentration in the 10-year part of the yield curve which outperformed 2 and 5-year yields by 5 bps and 6 bps respectively over the period.

What Didn`t Work In The Quarter

The portfolio did not have exposure to the insurance sector which was the best performing sector during the quarter.

Outlook

Central bank policies around the world are likely to remain friendly towards capital markets, while government policies are likely to remain less friendly towards the economy. The Canadian economy is slowing and the Bank of Canada's next move is likely lower. Consequently we expect Canadian bond yields to remain low, albeit with a noticeable level of volatility accentuated by less liquid markets.

Credit spreads will also be volatile, as poor economic prospects move in and out of investor consciousness, obfuscated by central bank interventions. We believe the most significant risk remains political, as electorates question government policy and politicians question both government and central bank policy.

The portfolio is positioned for yields to remain low and we will continue to look for opportunities to take advantage of yield curve volatility. The portfolio is overweight provincial and corporate sectors, with a bias for higher quality credits. We will continue to look for relative value opportunities between issuers and along the yield curve.

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