



**LORICA** | INVESTMENT  
COUNSEL INC.

## Focused Fixed Income

### Market Highlights

Central bankers are in charge and they are not about to allow fundamentals lead investors to think otherwise. The raft of disappointing economic data released in April was summarily dismissed in equity and credit markets which have become accustomed to the underpinning provided by the Fed, the European Central Bank, the Bank of England, and now the Bank of Japan. As US data releases continued to be worse than expected, the rumbling from the Fed was more QE not less, adding further fuel to already primed stock and corporate bond markets. (Note: Apple's 100 basis point 30-year yield spread on its \$17 B bond offering that was three times over-subscribed.) And despite the growing schisms surrounding the austerity debate among Eurozone members, periphery spreads narrowed, as the ECB indicated its preference for easier policy, ultimately lowering its policy rate by 25 bps on May 2nd. Finally, the Nikkei added another 11.8% and the Yen weakened by 3.5% against the US dollar as the BoJ went beyond its January commitment to a 2% inflation target by announcing it would purchase bonds to expand its balance sheet by 2% of GDP per month (roughly twice the size of the current US QE program).

The Treasury market's response to April's weak data was in-line with traditional investor behaviour – 10-year yields declined from 1.85% to 1.68% by the end of the month. April's US employment report (Non-Farm payrolls), which suggested perhaps more life left in the economy than indicated by the recent consumer and industrial data, provided a reprieve to falling yields and resulted in a rebound back to 1.74%. Government of Canada yields generally tracked the move in Treasuries, albeit with greater downside-propensity: a 1.76% fall to 1.69% in April, with a rebound back to 1.77% after Non-Farm. Although the employment report did have significant positive revisions to February and March, it was still only slightly positive, in that it still presents an average payroll number well-below the magic 200,000 net new jobs, and there was a significant decline in hours worked. We think that yields had likely moved too far too fast, and the report offered an opportunity for investors to reduce their long fixed income positions.

Canada's began to underperform Treasuries in late April, and this trend has continued into the beginning of May. Canada 10's and longs have underperformed similar-term treasuries by about 13 basis points, although current

Canada-US yield spreads are close to the averages of the last year. Steepening of the Canada 10's-long yield curve (now at 67 bps) slowed in April, after having steepened continuously since the beginning of the year (then at 57 bps). As for the front end of the Canadian yield curve (2's-10's) we have seen some flattening in March and again in April as 10-years have outperformed during the recent rally, while short term yields have been impacted by changing expectations for the Bank of Canada.

Overall returns for April were a lofty 1.14% according to the DEX Universe Index, to bring year-to-date returns to 1.84%. Looking at the Mid-Term Index (to remove the impact of different sector durations) provincial and corporate bonds delivered comparable returns for the month at 1.31% and 1.28% respectively, and only slightly outperformed Government of Canada's at 1.22%. However, for the year-to-date, corporates have been the clear best-performer at 3.56% for mid-term bonds versus provincials at 2.54% and Canada's at 2.05%.

### Outlook

We expect government yields to trade within a range, and after April's employment report, we are seeing a quick move back to the middle of that range. We will continue to look for opportunities to structure the portfolio to take advantage of market volatility. We also expect the slope of the Canada 10-long yield curve to continue steepening, moving closer to that of the U.S. curve. The portfolio is structured with an overweight in 10-years which, while offering a better overall yield, will also benefit from a steepening of the longer end of the yield curve. While the Canadian economy has shown signs of slower growth, we do not expect the Bank of Canada to indicate a policy shift (noting the imminent changing of the guard from Governor Carney to Poloz) in the near future, and hence expect short-term rates to be relatively stable for the time being.

The corporate bond market, like the equity markets, continues to receive its signals from the Fed. With the US economy not showing convincing signs of growth or inflation and not able to stand on its own, we don't expect the Fed to cease its quantitative easing programs any time soon. However, the risk/reward for holding corporate bonds looks increasingly unappealing, so we remain cautious. We are overweight corporate bonds and will remain so, with a preference for higher quality names.

**Gary Morris**, CFA  
President

**Thomas Gomes**, CPA, CFA  
Portfolio Manager