LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Bond markets had another tough month, as the market continued to grapple with impending QE *Tapering* by the Fed. The Canadian bond market returned -0.60% (DEX Universe Index), bringing the year-to-date return to -2.08%. For the month, corporates and provincial credit returned -0.67% and -0.63% respectively vs. -0.74% for Canada's (DEX Mid Term Index – for comparison purposes to eliminate duration differences). However, for the year, corporates are still the best performers by a significant margin, at 0.46% vs. provincials at -3.74% and Canada's at -2.08% (DEX Universe Index).

The yield curve steepened further in August, continuing a trend that has gathered momentum since May. The anchoring of short term rates is consistent with the tacit acceptance by investors that interest rate increases from the Fed and the Bank of Canada are still far off into the future, while *Tapering* of QE is more imminent. The Government of Canada 1-30 year yield curve steepened by 12 basis points in August and 69 bps since the year began. Notably, the middle of the yield curve, typically the most sensitive area, has been the worst performing part this year, with 10-years rising to August by 81 bps vs. 70 bps for long bonds.

If the main goal of the sequence of communication that Chairman Bernanke's initiated back in May was to introduce a measure of uncertainty into capital markets, his actions have largely succeeded. Investors are clearly more focused on the data and how they relate to QE *Tapering*; and markets now gyrate as investors try to interpret how the Fed will interpret the latest data. On the other hand, if higher yields portend an unintended economic slowdown, Bernanke's clumsily delivered messaging will not be viewed as favourably. Economic data was generally suggestive of imminent *Tapering* (65% of economists surveyed August 9-13 by Bloomberg expect *Tapering* to begin in September), thus pushing the trading range for Treasuries and Canada's higher. Ten-year Canada's are now trading between 2.50% to 2.75%.

The main engine of Canadian growth since the recession of 2008-9 has been the housing market and last year's slowdown appears to be just that – a slowdown, as more recent data have indicated a rebound in housing starts and solid sales prices. In contrast, the export sector continues be a drag on growth. Consequently, there has been no change from the Bank of Canada and we anticipate that any deviation from current policy under Governor Poloz will be gradual.

Outlook & Strategy

In our last quarterly strategy commentary "What We Think…" we outlined our argument for higher longer term yields and further steepening of the yield curve. We expect the yield curve could steepen an additional 25 bps this year. Beyond, we would expect a parallel shift of the yield curve, but only once investors anticipate a rise in short term interest rates. We do not foresee a re-flattening of the yield curve unless deflationary expectations rise – a scenario we consider as low-probability.

In our view, the case for QE *Tapering* and raising Fed Funds are entirely different and, although both are sensitive to the economy, have different thresholds. We see QE policy as tired, somewhat discredited, and now that Bernanke has outlined the case for *Tapering,* having outlived its usefulness – we expect QE to be wound down. Fed Funds however, will remain low to provide an anchor to the yield curve in an economy that has not demonstrated an ability to perform without central bank support.

SHORTER DURATION: The duration of the portfolio is now 4.6 years, 2 years shorter than the duration of the DEX Universe Index. The duration was shortened in June to protect the portfolio from further steepening of the yield curve. We have the ability and mandate to shorten the duration by as much as 4 years relative to the benchmark, but feel that while short term rates are anchored shortening the duration further is not warranted.

CORPORATE BONDS: The portfolio is overweight corporate bonds, but defensively so, with generally higher quality issues. While strong balance sheets and an improving economy are generally supportive of corporates, there still remains a big question mark as to how much quantitative easing has inflated corporate valuations. Anecdotally, we know of many investors who have entered the corporate bond market in the last few years, searching for yield pick-up with the confidence of supportive monetary policy. At the same, time market-makers have pared back their support of the market and investors are becoming less willing to buy corporate bonds. Thus *Tapering* of QE without continued economic improvement may result in wider corporate yield spreads.

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