LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The bond market in Q4 finally lived up to its billing, with US long-term treasury yields hitting highs for the year, albeit only on the last day of trading – 10-year and longs finished 2014 at 3.03% and 3.97% respectively. Government of Canada's had tracked treasuries for most of the year but outperformed in Q4 – tens and longs ended the year below their September highs at 2.77% and 3.24% respectively. The front ends of both the Treasury and Canada yield curves were more contained as investors took the lead from central bankers who projected restraint far into the future despite December's tapering of Fed asset purchases. Although investors had been anticipating an imminent start to tapering, the exact timing was much in debate (only 34% of economists surveyed by Bloomberg correctly anticipated the December start) such that yield volatility was substantial in Q4 – 10-year treasuries trading in a 50 basis point range.

During the quarter, bond investors had a host of conflicting information to contend with. US economic data showed general progress, supported by the wealth effect from soaring stock markets and firmer housing prices. At the same time, the rise in bond yields to September was sufficient to cause the Fed to acknowledge the potential impact of tighter financial conditions on the economy, which ultimately resulted in a temporary respite from higher yields. Fiscal policy, which had been in "retrenchment" (Fed) during the year, finally provided some lift with the Ryan-Murray negotiated bipartisan budget deal removing an element of uncertainty. Finally, downward trending inflation provided some offset to the normalization process of real yields.

Credit markets finished off the year in relatively strong shape. The short-lived rally in underlying governments in Q4 created the back-drop for issuers to take advantage of financing costs. Bond investors, who had obviously been hoarding cash during the Q3 backup, were up to the challenge and absorbed near record amounts of issuance in October and November. Yield spreads narrowed, although higher quality names slightly outperformed. Provincial bonds, which had been relative laggards, made up some ground in Q4, outperforming all other sectors, particularly in the long end.

Portfolio Activity

Confident that two year rates will remain somewhat anchored in a steepening yield curve scenario we took the opportunity to purchase a number of higher-yielding shorter-term corporates. The purchases additionally took advantage of a flattening of the credit curve and the widest senior versus subordinated bank debt yield spread basis of the year.

What Worked In The Quarter

The portfolio is structured with a short duration via a concentration in two year area of the yield curve in lieu of maturities 10 years and longer. For the quarter 5, 10 and 30 year yields rose by 8, 22, and 15 basis points respectively, whereas 2 year yields fell by 6 bps. The portfolio out-performed on this bear steepening move of the yield curve.

What Didn't Work In The Quarter

The portfolio's duration and yield curve exposure were more defensive and conservative than the benchmark, resulting in an overall lower yield. This was partially offset by an overweight in corporate bonds (primarily shorter-term) relative to the benchmark on a market value weight basis.

Outlook & Strategy

The normalization of bond yields has begun but, in our estimation, it will be a long and drawn-out process. The first move has been the normalization of the of the yield curve, which we believe is only part-way done and will require expectations of a full exit by the Fed from asset purchases to play out fully. We believe that it will still be some time before shorter term yields begin their move upwards, first steepening and then flattening the yield curve in the process. The move in US bonds will likely be tracked by Canadian bonds, albeit in a slightly more muted manner as Canadian real yields reflect weaker domestic economic prospects. Credit markets will likely remain stable so long as the rise in bond yields is limited to a normalization of the yield curve, but we do not see a strong case for further spread narrowing. Should investors become too aggressive and the Fed is unable to contain a further rise in yields, there is the possibility of more substantial declines to equity and credit markets.

We will maintain a relatively shorter duration in the portfolio until such time that we believe the yield curve has returned to a more normal shape. The overweight in credit will be kept to enhance the overall yield, with overall higher credit quality to protect against potential spread widening in the event of weaker market fundamentals.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com