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COUNSEL INC.

Focused Fixed Income

Market Highlights

Follow the Fed...

It has not always been easy to follow central bankers, as traditionally their communication has been deliberately nuanced and oftentimes opaque. (Of course our own illustrious Governor Carney has given new meaning to: following the leader of the central bank... which bank?) Of course analysing today's Fed, requires the analyst be an expert, not just on deciphering English, but on quantitative easing, and when and how it can be withdrawn. Despite QE, in many ways today's Fed has become less complicated. Under the leadership of Chairman Bernanke, the Fed has become far more transparent (following the lead of other dollar block central banks), to the point that when investors appear to have forgotten the most recent Fed message, Chairman Bernanke, hits them over the head with a reminder. And the reminder has been very clear, quantitative easing still has room to grow, and interest rates are on hold.

The war between Congress and the President and his allies in the Senate resurfaced in June, as if no-one expected it to. This time the battle was Sequestration, although it is really just a continuation of the ongoing budget war. While investors seem to be optimistic about a favourable truce and a limit to the casualties, the Fed, or more correctly Bernanke and his lieutenants, are not as confident. During the State of the Union Address and subsequent speech at the Annual Monetary/Macroeconomics Conference, Bernanke reinforced the message that the Fed is still concerned about the fundamentals of the recovery. Furthermore, the key leaders at the Fed – Bernanke and Yellen – appear not to be concerned about the Fed's impact on asset prices.

In contrast to the battles being fought in the U.S., north of the border there is perhaps a "calm before the storm". Data that was released during February paint a picture of a weakening economy, with few obvious areas of respite. A firming of commodity prices may help, although Canada's basket of commodities has not been nearly as buoyant as global commodity prices. Manufacturing continues to struggle with a further drop in the manufacturing trade balance from \$10.8 billion to \$12.7 billion in 2012. But most importantly consumer spending is shrinking as the housing market and related activities have slowed. Ultimately a slowing economy and growing unemployment will damage

the relative fiscal and monetary policy calm that has endeared Canada to foreign investors. Note the Canadian dollar has already declined by 3.78% against the U.S. dollar this year with 3.20% of the decline taking place in February (source: Bloomberg).

As for the bond market, the front end of the Canadian yield curve is lower than where it started the year; the back-end is more-or-less unchanged. Corporate yield spreads continue to benefit from the Fed determination, despite the relative appeal of the stock market. And, although flows into the equity markets have been substantial, flows into the bond market also been strong. Returns for the DEX Universe Bond Index are 0.25% year-to-date, with the Short Term Index returning 0.72% versus 0.76% for the Mid Term Index and -0.95% for the Long Term Index. The Corporate and Government indices have returned 0.88% and 0.00% respectively year-to-date.

Outlook

Although some investors got a bit carried away in January with declarations of the Great Rotation, we are not ready to write off bonds just yet. In our view, and that of the Fed, the environment for diminished quantitative easing and higher interest rates is still quite far off; so ultimately the yield curve will not be on a sustainable trend upwards. We had expected yields to be volatile and to trade within a range, and we are currently somewhere close to the middle of that range. As for the Bank of Canada, we are still of the belief that the next move for interest rates is down. We had increased the duration of our portfolios in anticipation of a move back down towards the lower end of the recent trading range – we are in the middle of that move – and have lowered the duration accordingly. We have also increased the overweight in the middle of the yield curve in anticipation of further steepening to the Canadian curve.

As for the corporate bond market, it is hard not to bet with the Fed, and we think the Fed's modus operandi is to support asset prices as an indirect stimulus to the economy through the wealth effect. However, we believe the amount of hot money in corporate bonds is significant – note the \$4.5 billion that went into Canadian high yield funds in 2012 – and vulnerable to a reverse in sentiment. We would rather remain overweight corporates, but with higher credit quality. However, we will continue to look for trading opportunities.