LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Bond yields ended January higher than where they started, adding to the move upwards that began in December. Ten year Government of Canada's and Treasuries both ended the month at 1.99%, rising by 19 and 23 basis points, respectively, after rises of 10 and 15 bps in December. The flip side to the rise in government yields was the narrowing in corporate yield spreads, particularly for lower quality credits. For example DEX Mid-Term Corporate BBB, A and AA yield spreads narrowed by 5, 7 and 1 bps respectively (after adjustments for the impact on the DEX corporate indices of credit rating changes to the debt of six Canadian banks).

After the nervousness that engulfed capital markets at the end of last year, related to the indecision around the *fiscal cliff*, investors were easily seduced by the apparent clear horizon that had miraculously appeared in front of the *cliff*. With no debt ceiling debate to worry about (until May), with the reassurance of more quantitative easing (not just from the Fed, but also now the BoJ), and with Europe's crisis now over (at least according to Mario Draghi – "*The darkest clouds over the Euro Area have subsided*.") investors were free to further bid up risky assets including equities and corporate bonds. Government bonds, offering measly yields were, predictably, not a popular destination for investors.

Proclamations of a "*once in a generation rotation into equities*" were plentiful, and analysts and commentators, including some respected by us, were quick to point out the significant retail flows into U.S. equity funds. The fact that bond funds, as well as money market funds, also had substantial inflows was generally ignored. We tend to agree with the explanation that early bonus and dividend payments, made to avoid U.S. tax increases, would have found their way to consumer spending as well as fund flows in all asset classes. Note that the early payments generated unseasonably large personal income growth of 2.6% in December (the most in eight years) versus an expected 0.8%. Ultimately, equity markets were up by a January record of 5% according to the S&P 500 and high yield markets were up by 1.38% according to the BofA Merrill Lynch U.S. High Yield Index.

As we had been anticipating, the picture of Canada's economy that emerged in January was not a particularly optimistic one. The housing market continued its downward trend as reported by the Canadian Real Estate Association, which had existing home sales down by 17% year-over-year as at December. The export sector did not provide better news, with Statscan reporting that the trade deficit widened to $1.96 billion in November. However, capital markets generally followed the lead from U.S. markets, despite divergent expectations for Canada and U.S. economies and somewhat incongruent monetary policies. There was a change in investor expectations for short term interest rates as the Bank of Canada appeared less *hawkish* in its Monetary Policy Report published during the month.

Outlook

Risky assets have gotten off to a gangbuster start, and it is hard not to argue with some of the reasoning: broad central bank support for capital markets and the deferral of government fiscal problems. However, as far as bonds are concerned, the environment for diminished quantitative easing and higher interest rates is still quite far off, so ultimately the yield curve should 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 higher end of that range. We have increased the duration of our portfolios in anticipation of a move back down towards the lower end of the range. We have seen this kind of volatility before, but we will be watching closely for signs that this is not a repeat of past behaviour.

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 a 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, and will continue to look for trading opportunities.

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