LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The bond market managed to narrowly deliver positive returns in July with the support of FOMC members who actively tried to talk the market up after it was so decisively talked down last quarter. Bernanke, having already tried to undo some of the market reaction to his tapering comments of May and June, continued at every opportunity to justify lower market yields. Investors paid attention begrudgingly and the Fed was marginally successful in reducing rates – 10 year yields closed as low as 2.47% from July's highs of 2.74%, but ended the month at 2.58%. In Canada, 10-year yields finished the month almost unchanged at 2.45%. In terms of total return, the Canadian DEX Universe index managed to eke out 0.19% for the month (after negative returns of -1.46% in May and -2.03 in June) due to outperformance by corporate and provincial credit.

Although the Fed has not been successful at pushing rates back down following the Q2 backup, it has managed to get investors to pay closer attention to the underlying economic data. It has also better-prepared the market for an eventual tapering of the QE program, while not inflicting damage to equity markets. The biggest casualty of the Fed's boggled communication has been the mortgage market where mortgage applications have fallen by 2.9% over the month, albeit mostly from a drop in *refi* activity, as long-term fixed rate mortgage rates have increased by 80 basis points since March. There has been limited impact on house prices and housing activity, but that may still be in the pipeline.

US economic data released in July's was mostly upbeat, with the notable exception of the labor report. Growth data which was expected to disappoint was better than expected and industrial reports also surprised to the upside, especially the June ISM manufacturing and non-manufacturing reports which both easily surpassed consensus forecasts. Yields mostly responded to the better data, but the weak payroll report (only 162k new jobs + downward revisions to the prior month) created some confusion for investors. Perhaps confusing matters more, was the further decline in the unemployment rate along with the continued decline of the participation rate – especially given the Fed's focus on unemployment as an explicit indicator for policy.
The Canadian data was also surprisingly good as consumers continued to display seemingly endless appetite for houses, despite having stretched balance sheets and facing higher mortgage rates. Data released for June showed starts, permits and prices all up. In contrast to the housing sector, the export sector displayed ongoing difficulties, particularly on the energy side, as a rise in prices was offset by a decline in volumes. Overall economic data warranted little change in short term rates while longer-term yields generally reflected moves in the US.

For the month, short, mid and long-term corporate yield spreads tightened by 1, 4 and 2 basis points respectively, resulting in absolute returns of 0.53%, 0.71% and 0.08% respectively according to the DEX Corporate Bond Index. Across the yield curve the best spread and absolute performance was reserved for telecom and cable – receding concerns related to Verizon's prospective entrance, and bank deposit notes – preference for high-rated, liquid issues. The weakest performers were retail – M&A activity, and real estate – supply overhang, and weaker credit metrics due to higher yields.

Outlook

The portfolio has been positioned for further steepening of the yield curve through a rise in long-term yields, which we expect to experience sometime in the second half of the year. With the Fed no longer providing explicit guidance for indefinite QE, investors require more compensation for taking duration risk further out the yield curve. We expect the *term (or duration) premium* to increase as QE tapering becomes more obvious. We believe that the Fed would like to eliminate the current QE program, and therefore as long as the economic data is mildly supportive, will initiate tapering this fall. Of course, some risk remains that weak employment or inflation data may reduce or prevent tapering. Short term yields will remain stable as investors are unlikely to anticipate any change to overnight rates.

Investors continue to be predisposed to the yield carry trade through an overweight in credit; however with the prospect of tapering on the horizon they appear less inclined to do so through higher-beta sectors and issues. From a credit quality perspective, the sector impacts of higher rates will be muted given that yields are merely transitioning from an ultra-low to a low interest rate environment. We do not expect any significant degradation in the general quality of credit as corporate fundamentals which in terms of leverage, liquidity and profitability remain sound. That said, the portfolio is structured defensively and has minimal exposure to sectors or issuers that will be negatively impacted by higher interest rates. We therefore, are well positioned to capitalize on relative value and yield enhancement opportunities as they present themselves.

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