



LORICA | INVESTMENT
COUNSEL INC.

Focused Fixed Income

Market Highlights

May was the weakest month for bonds since September 2008 which was also the second weakest in the last ten years. Ten year Treasuries backed up 46 basis points and Government of Canada 10-years followed suit rising by 37 basis points. So what was the catalyst? More of the Fed, except this time the Fed has been deliberately transparent in conveying a message of uncertainty, as opposed to being unambiguous in providing support to the bond market (in addition to other asset classes) through QE. That is not to say that it was outlining a timetable to reduce or taper QE, but rather it has created more confusion around the future of the QE program. The majority of investors interpreted the shift in communication from the Fed as indication that stimulus would be ending sooner rather than later and that substantial economic recovery is on the horizon. We think the Fed's goal was to attach a more balanced risk profile to their decision-making and reduce some of the risk-taking now prevalent in capital markets. In any event, we feel the knee-jerk reaction by bond investors is a bit extreme as economic data is still not convincing.

Looking at US economic data, we see two significant developments taking place: (1) the rise in housing starts, particularly multi-family, and (2) the deterioration in manufacturing. The housing market is clearly on an uptrend (May's data aside), led by investment in multi-unit construction. We are not seeing the follow through in single dwellings and we don't expect to see anywhere near the move seen in *multis*, as households are not taking on more mortgage debt, instead preferring to rent and spend their disposable income elsewhere. We are starting to see broader economic benefits from the housing sector, although not as much as would be expected from a resurgence in single home construction. As for the manufacturing sector, which has been an important contributor to a generally lack-lustre recovery, we are seeing weaker data (note May's negative ISM) suggesting that the weakness outside of the US is starting to take its toll on U.S. manufacturing exports.

We think it will be interesting times for the Bank of Canada, now that there is a new sheriff in town. As was to be

expected, incoming Bank Governor Poloz was left with the status quo and an opportunity to make his own mark in Ottawa. However, the Bank is facing export and housing sectors that are expected to slow (albeit the latter partially by design) and question marks where domestic consumption is concerned. Investors are relatively certain that the Bank will leave interest rates unchanged over the next 12 months, although the probability that there will be a move up has increased with the most recent jobs report. We believe there is room for change to this view, and will be keeping a close watch on the employment situation.

Outlook

We have stated before that we would see volatility in bond yields, but with no clear trend, and believe that May's actions are consistent with this view. Investors cannot be completely faulted for reacting with such ferocity to the disparity of communication coming from the Fed; after all they have become accustomed to the unequivocal support in the form of QE – any doubts about QE would likely have a significant psychological impact. However, as long as the economic news is mixed we don't anticipate a change in course from the Fed, only more symmetry around the risks investors place on the Fed's decision-making. We are likely close to the upper end of a range in yields and are not yet ready to yield to a new higher trading range. We will continue to actively manage the duration around the movement in this range.

We think that the real agenda behind the messaging from the Fed, has been to cajole investors into re-pricing investment risk in riskier assets, which has sunk to very low levels. The knee-jerk response has been to punish Treasuries (Bank of Canada's included), but we think that over time investors will translate this re-pricing more fully across a broader range of assets. While a decline in prices will translate into negative returns in any asset classes, we don't think long-duration Treasuries or Government of Canada's warrant being singled out here. We anticipate yield spreads on riskier credit will edge wider (we have seen this move in the US) and are holding higher quality corporates for just this scenario.