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LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Ever since the Fed began its QE program, the fortunes of the corporate bond market have been more closely tied to those of riskier assets than those of the government bonds. Although 10-year Government of Canada yields troughed in June of 2012 and again in April of this year, and have risen about 100 basis points to current levels since April, corporate yield spreads have mostly maintained their narrowing bias. Current Corporate yield spreads are only about 10 basis points wider (according to the DEX mid-term indices) than their lows experienced three times since the credit crisis and most recently this June. In past cycles, it would not be unexpected to see corporate yield spreads narrow in the shadows of a steepening yield curve, such as we are seeing today. However, the kind of consistent narrowing of corporate yield spreads in the face of a flattening yield curve, as experienced from the fourth quarter of 2011 to May of this year, is somewhat inconsistent with past cycles. We believe that quantitative easing has pulled investors into the corporate bond market and, consequently, pushed yield spreads tighter than justified by economic fundamentals. If asset purchases taper, as we anticipate they will, it is not clear to us that a steepening yield curve will coincide with stable to tighter yield spreads.

In light of relatively tight yield spreads, corporate issuers have taken advantage of inherent corporate bond demand. November's corporate bond issuance was $12.2 billion, easily surpassing the previous November record of $7.1 billion in 2010 (which benefitted from the pent-up supply following the credit crisis). Although overall asset flows into bonds have receded, captive demand for corporate bonds is still enormous on a relative basis, particularly in Canada where institutional investors such as insurers and pension funds dominate the landscape. During the month, investors seemed content to put cash to work and capitalize on attractive yield spread concessions that resulted in immediate gains. Unfortunately for buyers, the movement of the yield curve, which was steepening through the month, ensured some losses, particularly for longer term debt. In contrast to the last few years, investor demand w*a*s significantly narrower as crossover investors were largely absent – likely being pre-occupied with activity in equity markets. Also, longer term issues, not surprisingly, only had appeal to investors with natural duration demands, while shorter term issues were taken up by a broader investor base.

We, like many others, believe that the fortunes of the bond market are captive to the intentions and actions of the Fed. And although the Fed has been intent on being more transparent about its intentions, we do not feel any more well-informed. What was once an explicit activity of deciphering brief and cryptic Fed statements and the occasional testimony has morphed into an implicit activity of deciphering voluminous and contradictory communication from a myriad of FOMC sources. Yes, bond yields are grudgingly moving with fundamental data, a so-called data dependency, but the conviction is weak, as investors are clearly uncertain as to how the Fed itself, interprets the data – a clear failing of the logic of the Fed's transparency goals. While November's data was mixed, we feel there was enough of a majority of data points indicating economic strength, that tapering of asset purchases this year must be, at least, up for discussion. Ten-year treasuries and government of Canada's rose by 19 and 13 basis points respectively during the month, suggesting that market participants are in general agreement with this view.

Outlook & Strategy

We expect the Fed to begin its much overdue winding down of its asset purchase program by no later than the first quarter of next year, assuming no unforeseen shock to the US economy. There is still some likelihood of tapering commencing this year, an eventuality that will have further steepening impact on the US and Canadian yield curves. As we have highlighted previously, the benefits of QE are, in our minds, becoming increasingly questionable and the costs increasingly insupportable. We have positioned the portfolio for a steepening of the yield curve which should continue over the next few quarters. Credit-wise, the portfolio is structured defensively and has minimal exposure to sectors or issuers that would be negatively impacted by higher interest rates.

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