October 31, 2013

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

There has been no looking back for stock and bond markets since September's reprieve, albeit only temporary, from Fed Tapering. September's US employment report, which was delayed until October 22nd because of the US government shut-down, was disappointing and provided ample fodder for the Taper-2014 camp. The Fed appeared happy to further sustain already well-fed (pun intended) investors, with scant indication of feared tapering in their October FOMC meeting statement. From the September FOMC meeting, when the Fed disappointed investors with no tapering announcement, until the end of October, the S&P 500 has risen an additional 3.5% and 10-Year treasury yields have fallen 33 basis points. Ten-year Government of Canada yields have also fallen by 36 bps.

Although the fall in bond yields since September 17th has been significant, less than half of the rise that took place since the beginning of May, when the then released Fed minutes indicated asset purchases would eventually be adjusted, has been erased. This is an important point, as to us it appears that, while bond investors are willing to take on duration exposure, this willingness is limited due to the expectation that tapering could begin soon. Clearly, the Fed's asset purchases are having a significant impact on the market with the current purchase rate of $40 B in US Treasuries and $45 B in mortgage securities accounting for 62% and 33% of monthly issuance, on average for the year, in their respective markets. Furthermore, the Fed is now in control of over 30% of the Treasury market in terms of duration (using 10-year equivalents) from under 10% just four years ago.

Until the US ceiling stalemate was resolved on October 16th (ultimately as part of a last minute deferral to January) markets traded nervously in the absence of government data. Available reports, which included a decline in industrial indices, weaker claims numbers, and a fall in consumer confidence, did suggest a negative impact from the government shut-down, which was corroborated once government data was released later in the month. Realistically, investors will have to wait for cleaner data when the government shut-down is no longer reflected in the numbers and when a longer-term resolution to the debt-ceiling conflict is established, before the strength of the economy can be accurately gauged. However, the data will likely be interpreted as understating the underlying strength of the economy.

Outlook & Strategy

In Canada, the Bank of Canada stole the show by surprising investors with a more downbeat outlook for the economy and removal of the hawkish bias from monetary policy. While on the surface, the shift appears substantive, investors had already adjusted to a more neutral monetary policy, with the efficacy of the bank's hawkish stance having already come into question. The other surprise was the resilience of the Canadian housing market, with both housing starts and house prices showing surprising underlying strength.

Although we are heading into a traditionally quiet period for monetary policy, we expect the tapering decision to continue to loom over capital markets right through to year-end. We cannot rely on the Fed to effectively communicate policy and guide the bond market and thus would rather follow the data. We believe there is still a chance for tapering to begin this year but, more importantly, that investors will attach enough probability of this happening to maintain upward pressure on bond yields. We are in a period, where the backend of the Canadian yield curve will largely be guided by the backend of the US yield curve and therefore are at the lower end of the trading range on 10-year and long Government of Canada bonds.

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