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What We Think……

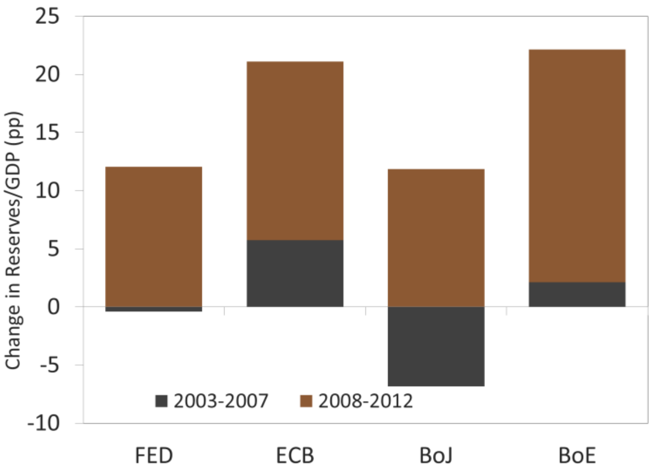
Managing bonds is, at the best of times, not an easy pursuit – but why should it be? This is truly a stimulating endeavour and there are many worse things in the world that one could be doing that are equally difficult. A few decades ago, when we bond managers were largely relegated to the sidelines by our more-celebrated equity cousins, one could be faulted for assuming that fixed income management was pedestrian and rather straight-forward. After all, slot a few bonds into the portfolio and let the equity markets do the rest. Of course, bond returns were double-digit back then, but nobody much cared. Today's world is much different; bond returns are undeniably single digit (and potentially negative), yet people pay considerably more attention to what bond guys have to say – think Bill Gross and Jeffrey Gundlach.

For most, the investment world has certainly gotten more confusing – at least by the paradigm established decades ago. As a bond investor, one would follow the economic data (non-farm payrolls was always the key and, for a time, I remember paying particularly close attention to the employment cost index) and the outlook for the economy, inflation, and the bond market would fall into place. Of course there were exogenous shocks: Long Term Capital, the dot.com bust, and more, but they seemed to be one-offs that would never really get in the way of the longer term trend. And while it did not always seem like we were in a trend of such significant proportions – it has been undeniably that. Since those dark days in the 80's, we have been on a steady march downwards in yields, punctuated by only momentary rises.

We could always count on the Fed! During the Greenspan years, the Fed Chairman would talk a tough game and could be expected to deliver a measure of Fed-speak that would leave the markets searching. But ultimately, the Fed's actions were pretty much in baby-steps that never really took the bond market out of its slow progression. Yes, with the benefit of hindsight, one could argue that Greenspan's Fed only knew one direction for interest rates and that was down, although at the time it didn't always seem that way. The years of 1994 and 1999 – both years when the Fed was raising rates and U.S. bond market returns were negative – did give Fed policy an air of balance, however short-lived.

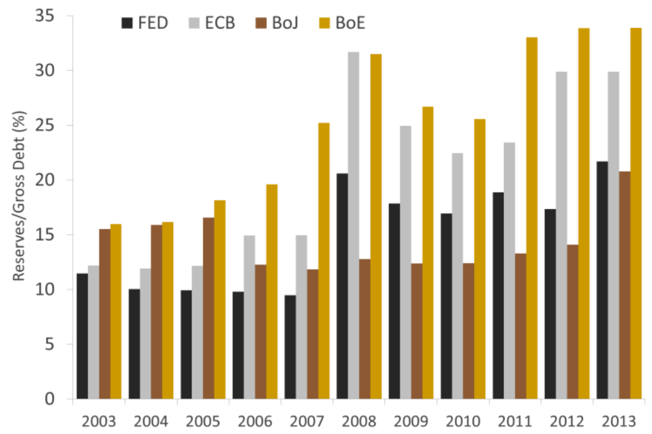
Today, one might argue that figuring out the bond market is still largely about figuring out the economy, and perhaps at some level that may be true. However, in this era of central bank experimentation, the relationship between economic data and the price of bonds seem far less obvious. As central banks have expanded their footprint, their direct influence on yields has also expanded. What's more, the feedback loops from central bank policies, while perhaps not having strengthened, have certainly multiplied. For example, the Fed can no longer be thought of as operating mostly around the edges, tweaking interest rates, in order to nudge an economy temporarily out-of-line. For starters, the economy no longer appears as sensitive to short term interest rate moves as it once did (not that there is any room left for rates to go in the U.S. anyways). But more importantly, the Fed has taken so much direct intervention that it is no longer obvious what bond market action is the result of Fed intervention and what is the result of investor sentiment and activity. Yields have always been impacted by technical factors, such as issuance patterns and foreign purchases, and we have always tried to account for them in establishing our views, it is just that now with QE programs, the technical factors are disproportionately large.

Figure 1 - Change In Central Bank Reserves



Source: Eurostat, FRB, Bank of England, Bank of Japan, ECB & Lorica Investment Counsel, as at March 2013.

Figure 2 - Central Bank Reserves vs Gross Debt*



**2013 Data based on Lorica's projection.*

Source: IMF, FRB, BoE, BoJ, ECB, Lorica Investment Counsel, as at March 2013.

Layer on the political shocks that were once unexpected, but are now only unexpected in their timing, and one can see why a bond investor finds an investment paradigm in need of a retrofit. And it is not just sovereign yield curves that have been impacted. In some respect, distortions are even more egregious in the credit markets, where liquidity is more of an issue and retail investor behaviour more relevant. So what are we to make of the bond market during this period of excessive intervention, and are we in the midst of a temporary paradigm shift or one that will have legs?

Figure 1 shows the balance sheet changes of the major central banks prior to and following the credit crisis. There is not much to tell before the crisis, but clearly we have seen monetary expansion on an unprecedented scale. Another way of looking at this monetary expansion is shown in Figure 2, where we show the balance sheet expansion in terms of gross government debt of the largest central banks. Given the magnitude of central bank holdings, it is not surprising that central bank reserves are distorting not just government bond markets, but credit markets as well. Furthermore, it is wrong to believe that impacts are localized… capital flows are global and impacts on one market can have an impact elsewhere. Look at last week's BoJ announcement regarding future asset purchases – the announcement clearly had an impact it had on not just the JGB market, but also on global government bond markets.

But what about secondary impacts? It was a lot simpler when most central bank policy could be analysed in terms of interest rate changes and the channels through which they would impact bond markets were fairly well understood. Today, guidance and QE are the central bank tools of choice and the secondary impacts seem to be far more important than the primary ones (or perhaps we are just unsure what are in fact intended as primary and secondary goals). Conventionally, Fed policy was used to directly target short term rates, while the market was left to do the job of translating policy along the rest of the yield curve and broader capital markets. Today, Fed policy is less subtle. The Fed now includes the entire yield curve in its toolbox and beyond that, various credit curves are also within their scope. Refer to Figure 3 for the most recent breakdown of Fed holdings.

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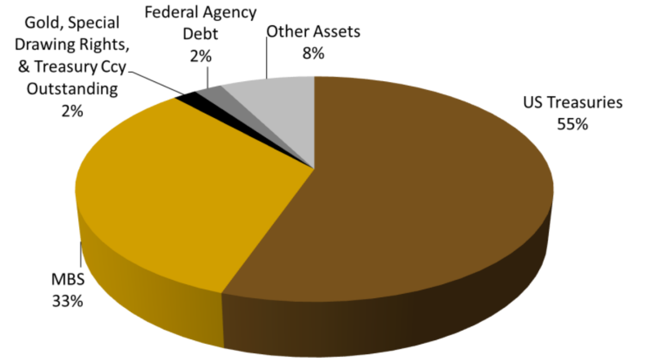
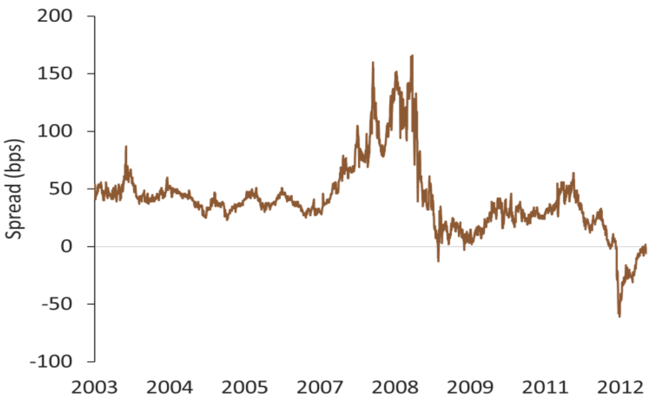
Figure 3 - Fed Balance Sheet Breakdown



Source: Federal Reserve Board & Lorica Investment Counsel, as at March 2013.

The Fed has clearly been a substantial buyer of agency mortgage backed securities. By doing so the Fed has not only been able to narrow MBS yield spreads (see the Figure 4), but they have also narrowed yield spreads in other parts of the credit markets. As the Fed has removed high quality investments such as treasuries and agency MBS from the market through asset purchases, it has pushed investors towards more risky corporate bonds and even equities. This has had repercussions beyond the U.S., as we have seen corporate yield spreads narrow globally. And given behaviour of the equity markets, one could be forgiven for assuming the Fed was directly active there as well.

Figure 4 - US Agency MBS (FNMA) Current Coupon OAS



Source: Bank of America, Merrill Lynch & Lorica Investment Counsel, as at March 2013.

In the past, much of the transmission mechanism of Fed policy was the responsibility of market participants who would have responded to Fed policy in conjunction with their own expectations, by moving the yield curve. Although market reactions were sometimes exaggerated, investor participation generally meant a more gradual market response. Today, the job of market participants has been impeded by the Fed, who, through direct asset purchases, has taken on a greater role in the market's price-setting process and consequently distorted the outcomes. Although the Fed has gone to significant lengths to create an aura of transparency around their asset purchase programs, the reality is that investors have much greater anxiety and uncertainty relating to the bond markets price setting mechanisms than before. In the U.S. Treasury market, quantitative monetary policy now plays a disproportionate role in pricing the yield curve, displacing other factors such as fiscal policy, inflation expectations, etc.

But the effects of current Fed policy have not been limited to the bond market, the equity and currency markets have also been big beneficiaries. Since the Fed announced QE3 in September of last year, the S&P 500 has rallied by 9.1%, despite growth of 1.3% in Q4 2012 and economist expectations for growth over the following 12 months of 1.9% (according to Bloomberg's survey of bank economists). Rather than earnings per share growth driving stock market returns, it has been price earnings multiples which have expanded from 16.6-times to 17.9-times – in our view, a direct result of the money creation of the Fed and the concomitant risk taking by investors. Although, the Fed would never admit to targeting asset prices, not to mention equity prices, the ability to orchestrate traditional Fed policy through targeting interest rates has been somewhat incapacitated with the decline in the rate structure. Admittedly, there has been some success, albeit fleeting, from the wealth effect generated by a rebound in the housing and stock markets. But from a more cynical perspective, one has to wonder about the durability of a stock

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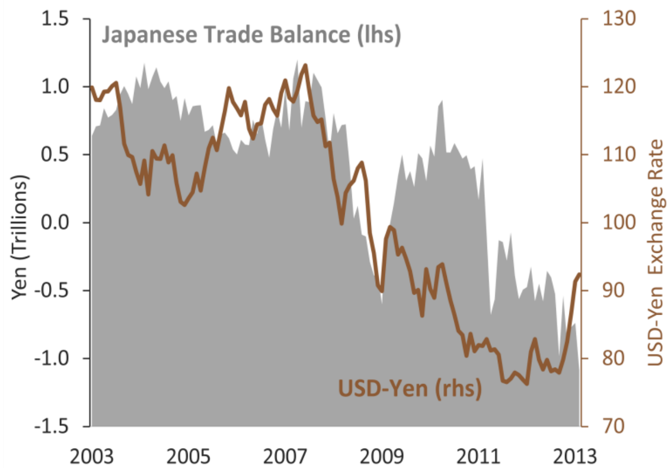
rebound not driven by economic fundamentals, however the best intentions of monetary authorities. One would also have to wonder if grasping onto the wealth effect to drive the economic recovery is grasping at straws.

The other direct jolt from the Fed's QE programs has been to the U.S. dollar. Unlike the equity markets, when it comes to currencies, the Fed does not operate alone, but needs the cooperation, or at least tacit compliance, of other central banks. For most of the duration of Fed's QE programs, it has only had the BoE to contend with – and really the BoE is only a marginal player in the context of the Fed. As for the ECB, it has been lowering rates grudgingly and has not been buying assets (under the announced OMT program), only rumbling that it would.

In 2010, the Bank of Japan halted its last QE program. Going back to the early 2000's, the BoJ had attempted two major episodes of QE, largely thought to have been ineffective. However, following the election of right-wing Prime Minister Shinzo Abe last December and the appointment of a new Bank Governor, Haruhiko Kuroda, Abe has given Kuroda new marching orders to generate 2% inflation over the next two years. The BoJ has decided to resume quantitative easing on a massive scale – equivalent to 2.7-times the scale of the current U.S. program. A new QE program for the BoJ will weaken the yen – we have already seen a 15.5% decline versus the USD following Abe's initial directive. Figure 5 shows Japan's trade deficit with the U.S. versus Dollar-Yen – Prime Ministger Abe would like to see an improvement in Japan's export picture. QE has arguably had effectiveness beyond the yield curve, and there is little doubt that the Japanese government would like to see some comparable benefits from its own large scale asset purchase program. When it comes to currencies, QE is not agnostic, nor does it operate in a silo. It will be interesting to see the impact on not just U.S. and Japanese trade, but also Chinese trade from a devaluation of the Yen.

Figure 5 - Japanese Trade Balance vs USD-Yen



Source: Ministry of Finance Japan, Bloomberg & Lorica Investment Counsel, as at March 2013.

Are currencies and equity prices secondary considerations for the Fed? It is difficult to prove one way or another. Nevertheless, we have seen evidence of the wealth effect and trade translating into the broader economy, although less convincing in terms of longevity. A wealth effect only realised by a narrow group of investors cannot be counted on for durable consumption growth. Similarly, a resurgence in exports based on currency devaluation rather than a manufacturing renaissance cannot be counted on for sustainable job growth.

There is no question that the Fed and its colleagues at other asset buying central banks have redefined the relationship between monetary policy and markets. What's more, the longer current policies continue and the further investors are removed from the old model of interest rate policy intervention, the less likely we are to revert back to the old paradigm of the economy, monetary policy, and the bond market in a graceful manner. Reversing the policy course that has taken years to implement will not happen suddenly and just as its implementation has been met with uncertainty over its course and duration; so likely, too, will be its withdrawal.

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