LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

It has been as if a higher being has ordained that bond yields would not rise in 2014. We have been clear in our beliefs that government yields would continue the normalization process that began last year, but who could have forecasted such a severe winter? Or a return to a Soviet-era mentality in Russia, fresh off the goodwill of the Sochi Olympics? (Yes there was controversy leading up to the Olympic Games, but that was also true in Beijing – no geopolitical fallout of Olympic proportions there.) Now, that the US economy is finally showing clear signs of rebounding, these extraneous shocks have gummed-up the traditional bond market mechanisms for pricing in higher growth and the potential for higher inflation. Mechanisms, we had expected to return to working-order as the Fed proceeds through its much overdue exit from QE.

Admittedly, there is still left-overs of the winter weather to fully digest – first quarter US GDP growth was only just announced on April 30th to be a disappointing 0.1% QoQ SAAR (compared to an already low consensus of 1.2%). But real-time data has begun to tick-up, which should be catching the eye of investors. Non-farm payrolls came in at a very robust and consensus-beating 288K, and the unemployment rate declined to a noteworthy 6.3% - however you wish to explain it. In terms of wages, average hourly earnings were very non-threatening, with no monthly change. However, even the most stubborn frictional unemployment proponents (Janet Yellen included) would have to take notice that this rate continues to drop relatively unabated.

We do not consider the US economy to be completely out of the woods. Housing is still not convincing – we think there may have been too significant an institutional component to the rebound of the last few years. However, mortgage rates are still low and supportive. In addition, the US should continue to be an attractive destination to foreign investors who see the US multi-family sector as a relatively secure and well-valued investment opportunity. And while both ISM manufacturing and non-manufacturing reports are pointing up, there has been enough weather effect in industrial data more generally, to leave a little room for doubt as to the veracity of recovery.

There are also concerns globally with Europe struggling with low growth and deflationary concerns – the ECB sights downside risks to growth, but seem more confident that inflation will rise to more comfortable levels. Growth has also slowed in the Chinese economy to its slowest pace in the last 18 months, but we are less concerned, given China's record as a managed economy.

Outlook & Strategy

In last month's commentary, we had suggested that further escalation of the Ukraine situation was neither in the best interest of Russia nor Ukraine and its allies, and therefore cooler heads would prevail. With the passing of another month of unrest, it is apparent that it may be hard to predict the path of this conflict, and until there is more clarity, markets will reflect a level of uncertainty. That being said, we don't think that the Russia-Ukraine conflict will ultimately be able to obscure the returning strength of the US economy. There may very-well be a lower trajectory to yields, but we still believe that they will rise.

Over the last few years, we have found the trans-parency of the Fed ironically more confusing and less predictable (moving targets have something to do with this.) Early indications are that Chairwoman Yellen will not deviate much from the methods of Bernanke, although this still has to be played out. In any event, our sense is that the Fed is still concerned about growth and employment and will not likely signal its intention to raise interest rates for some time. However, with better data in the horizon, we are still confident that the yield curve will steepen this year. We will maintain the short duration bias in the portfolio.

As for credit, the portfolio is structured conservatively and has minimal exposure to sectors or issuers that would be negatively impacted in the event of higher interest rates. We are also well positioned to capitalize on relative value and yield enhancement opportunities.

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