LORICA | INVESTMENT COUNSEL INC.

August 31, 2014

Focused Fixed Income

Market Highlights

Back before the Fed hijacked the bond market, it was typical for us to formulate our market view based on a range of factors that included: economic fundamentals, flow of fund data, geopolitical events, capital market valuation, bond supply, and of course monetary policy. Not surprisingly monetary policy would generally have the greatest weight, but it was typically informed by the economic environment – mostly inflation, but in the US, also growth as revealed through unemployment.

We still look at the full range of factors, but since the Fed adopted its unilateral stimulus following the Credit Crisis (the Bank of Canada has sat patiently on the sidelines), it has been as if the only thing that has mattered to the bond market has been the Fed. And that Fed has been devoutly asymmetric, implementing successive actions of more monetary stimulus – whether explicit such as QE or implicit such as forward guidance. As the Fed's easy policy has been progressively more ensconced in pyschology, mostly factors supporting its policies have supported the bond market, while factors challenging them have been largely dismissed. "Don't fight the Fed" has proven to be the right strategy.

Of course, one can argue opposing versions of reality: (i) a deflationary world where Japan and Europe are just the leading edge of economies with low growth and high debt – stubbornly on the verge of deflation, necessitating central bank intervention; vs. (ii) a cyclical world where the US economy is entering a period of self-sustaining growth that will lead other less dynamic economies forward. We subscribe partially to the latter, although we are less confident of the US's ability to be the catalyst for structurally challenged economies.

It should not be a surprise then that so far in 2014 we have seen cause for further bond yield declines as the Fed has made a point of emphasizing its dovish credentials while a couple of unpredictable events – extreme winter weather and Ukraine-Russian crisis have provided additional support. A year ago, the economy did not present as strong as it does today, but Bernanke's Jackson Hole comments were misconstrued as a forewarning of imminent Fed tightening and investors reacted accordingly. Today with almost uniformly more positive economic data, Yellen's Jackson Hole comments are unmistakeably still *easy* and investors have reacted accordingly.

Canadian and US bond yields fell again in August in response to further geopolitical unrest in the Ukraine and the Middle East and diminutive European yields that have prompted flows into the higher yielding, US bond market. For the month Government of Canada 10-year and long bonds have returned 1.6% and 3.1% respectively; more impressive are the year-to-date returns of 9.8% and 16.6% respectively. Credit markets appeared a tad more vulnerable during the month, with returns increasing with credit quality.

Outlook & Strategy

We are beginning to see some signs of an end to 2014's unexpected bond market rally. The German yield curve is approaching the level of the Japanese yield curve leaving less room for expansion of flows from the European bond market into the US bond market. And, as of the time of writing, the likelihood of an escalation of fighting in the Ukraine has been greatly reduced, now that it is obvious that Russian troops have fought inside of east Ukraine and NATO has no intentions of stepping into help. (Note however, that we are not naive to believe that with the latest peace agreement, hostilities are gone for good.) Most importantly, we don't believe the Fed can be counted on to remain entrenched in its position for much longer. For the time being Janet Yellen seems to have turned the discussion almost entirely to the tightness of the labour force or the lack of tightness, as Chairwoman Yellen sees it. We feel the market has begun to sniff that the labour markets may not be sufficient rationale for the Fed to sustain its current position – given the low level of the unemployment rate and the varying interpretations of employment and the participation rate. It only remains for the Fed to acknowledge a policy rate change is in the horizon for bond yields to undergo an abrupt adjustment upwards.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com