LORICA | INVESTMENT COUNSEL INC.

# Focused Fixed Income

## Market Highlights

February turned out to be a surprisingly good month for North American government bonds, as investors responded to weak data and troubling geopolitical events in the back half of the month. Investors were forced to reason their way through January's weak US economic data – trying to establish just how much of the weakness was weather-related versus genuine slowdown. At the same time, investors also had cause to resume the risk-off trade into bonds in response to events in the Ukraine. It would appear that any goodwill for the markets (a stock market benefit from the Olympics has been demonstrated, albeit for the summer games), not to mention Russia, emanating from the Sochi Olympics were quickly forgotten.

US economic data drew concerns on many fronts. On the consumer side, retail sales were down (-0.4% mom), impacted by very weak auto sales which were somewhat offset by higher gas prices – clearly households were not in the mood to go shopping, particularly for new cars that would soon be covered in salt. On the housing front, existing home sales were down, but new home sales were surprisingly strong; of more concern was the significant drop in housing starts (-16% mom) and building permits (-5.4% mom). Although analysts reasoned a weather impact on housing starts, some are concerned about the continuous decline in permits since last October. On the industrial front, manufacturing data, released later in the month, presented a dim view of the economy; although the fact that data released earlier on was more positive, suggests a significant weather impact progressively through the month. Finally, the employment report for January was also weak. For those espousing the weather theme, consumer confidence surveys were a source of optimism, not showing the significant ill effects from either the weather or weaker equity markets.

Overall, Canadian government yields rose slightly during the month with the FTSE TMX Canadian non-Agency Universe index yield rising from 1.70% to 1.75%. The Canadian market maintained its outperformance of the US market throughout most of the month, until the late surge by Treasuries at month-end, when investors fled to the safety of US bonds and dollars. Canada-US 10-year yield spreads ended the month at -24 basis points after dipping to -33 bps at the end of January. Canadian short-term yields rose slightly during the month as investors had more time to rethink their expectations for lower overnight rates that were formed following January's Bank of Canada statement and MPR. In performance terms, the slight rise in yields was not enough to offset income, resulting in an overall return of 0.35% for the Universe index for the month.

Interestingly, this year's decline in yields of real return bonds has been greater than for nominal bonds (of similar duration) – an indication that the move in bonds has been mostly about a fall in real yields versus a change of inflation expectations. A significant byproduct of quantitative easing has been the distortion of real bond yields. As we work our way through the exit from QE and shifting economic expectations (clearly aggravated by weather conditions), it is important to note that real yields are going through a significant adjustment process and will likely continue to be very volatile. The magnitude of QE's impact on real yields is largely unknown and investors are in the process of working their way through the effects.

## Outlook & Strategy

The portfolio has been positioned for a steepening of the Canadian yield curve, which, given the challenging global backdrop and disruptive North American weather, will likely take longer to unfold. We believe the flight to safety of the bond market is temporary and will reverse as the effect of Fed tapering re-asserts itself (instructively the Fed does not show any hints of changing course) and investors gain more confidence in the developing US recovery. We are still of the view that corporate bonds offer a reasonable yield pickup but that the scope for spread narrowing is limited. We will maintain the portfolio's overall short duration and overweight in credit and will continue to look for opportunities on a relative value basis.

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