January 31, 2014

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Investors got more than just a jolt of cold weather in January as the winter weather permeated equity markets globally (even in the summer southern hemisphere), erasing some of last year's lofty gains. The biggest losses were in emerging markets where the MSCI Emerging Markets index lost 6.6% in USD terms in January. Closer to home, the S&P 500 and S&P TSX lost 3.6% and 3.8% in US dollar terms respectively. As investors fled equities, government bonds rallied with 10-year treasury and Canada yields falling 36 and 33 basis points respectively. The move was clearly reminiscent of the "risk off" trades so common before last year's huge run-up in equity markets.

Canada's strong bond market performance was in spite of a tug-of-war between several conflicting narratives impacting the market. On the one hand global investors have pared back their consumption of Canadian fixed income, including a significant amount of corporates, in response to negative sentiment on the Canadian economy and dollar. On the other, the Bank of Canada has been aggressively talking down the yield curve and currency with its far more dovish stance under governor Poloz (in comparison to a consistent tightening bias under Carney) and concern over deflationary risks. The Canadian yield curve flattened by just over 30 basis points (when comparing 30-year yields to overnight rates), moving from 223 bps to 192 bps over the month. Perhaps the bigger story though, was the 4.4% depreciation of the Canadian dollar during January – we would interpret as somewhat of a policy success for the Bank.

The FTSE TMX Canada Universe Bond Index (yes, the name has changed) returned a lofty 2.60% for the month. Corporate bonds were the best performing sector, followed by Canada's and then provincials. Corporate yield spreads narrowed marginally adding to the capital gains from falling government yields. That was not the case for provincials, where there was more "give-back" of the spread narrowing from Q4 of last year.

Although foreign demand for corporates waned somewhat, domestic investors proved more than capable of digesting new issue supply – there was $6.6 billion during the month which was down from $9.4 billion a year ago. The corporate deals that did come to market were heavily oversubscribed and generally, with a few notable exceptions, performed well in the secondary market. Issuance was dominated by the banks (four senior deals totaling $3.8 billion) and real estate (five deals totaling $625 million). The real estate deals were particularly noteworthy as these unsecured issues came at attractive levels relative to where secured debt could be placed with banks.

Outlook & Strategy

The portfolio has been positioned for a steepening of the Canadian yield curve; in January we saw anything but a steepening, as Canadian longer term bonds followed the relentless flight to treasuries. We still believe that the direction for longer term Canadian yields is up, despite the Bank of Canada's gestures otherwise. The current flight to safety is temporary and will reverse as Fed tapering re-asserts itself and investors again gravitate towards the developing US recovery. We are still of the view that corporate bonds will offer a reasonable yield pickup but that the scope for spread narrowing is limited. We will maintain a short duration position and overweight in credit but look for opportunities on a relative value basis.

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