LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The Canadian bond market returned a healthy 1.22% during May driving year-to-date returns to a lofty 4.55%, according to the FTSE TMX Canada Universe Bond Index. Corporate bonds only marginally outperformed Government of Canada's on a duration-adjusted basis during the month (Mid Term Corporates returned 1.26% versus Canada's at 1.08% and Provincials at 1.27%). This year, corporate bonds have outperformed Canada bonds 4.54% versus 3.72%, according to the Universe Index with the excess gains largely coming in the first quarter. Looking at the Mid Term Index to eliminate the impact of duration differences, Corporates returned 5.82% versus Canada's at 4.60% year-to-date, compared to Corporates at 3.85% and Canada's at 2.99% for Q1.

Yields trended downwards through most May, resulting in relatively low overall market volatility. For example 20-Day volatility for daily 10-year Government of Canada yields bottomed on May 9th at 15% (similar levels last seen last October) when yields were at 2.36%. Volatility started to rise towards the end of the month, but was still well below the average of the last couple of years. We see a certain level of investor complacency having set in, as bond investors appear to be largely positioned for higher yields and content to sit on the sidelines. According to Merrill Lynch FX and Rates Sentiment Survey – May 2014, over 80% of respondents expect higher Treasury yields by year-end. And according to the Securities Industry and Financial Market Association, year-to-date as at the end of April U.S. Bond Markets Average Daily Trading Volumes are down 13% versus the same period a year ago.

The marginal trade in North American bond markets has been able to push yields far lower than most investors had expected, and willing or possessing the fire power to fight, at this juncture. US economic data, on the whole, continues to improve, albeit not fast enough for many bond investors and it only remains for the May employment report for further confirmation of this trend trend. On the other hand, Europe continues to offer rationale for some investors to direct investment to North America, even at the current low yields – Russia/Ukraine continues to provoke some level of flight to safety; and European deflation concerns and accompanying low sovereign rates make NA rates more appealing.

Outlook & Strategy

We have not deviated from our view that the US economic picture is improving. There are notable downside risks coming from the housing and export markets, but we think there is enough strength in the underlying labour markets to raise growth in the second half of the year. We don't see inflation or deflation as viable concerns, but we note some pockets of labour force pressure that may translate into more wage growth. For what it is worth (we say this only because the Fed has been far more difficult to predict in this era of constant and unreliable communication), we don't anticipate any departure from the current path by the Fed. QE will end this year, although reinvestment of coupon payments will continue, and we don't expect any indication of a move on short rates.

The portfolio is positioned for the yield curve to steepen as we expect underlying economic strength to eventually outweigh the impact of foreign investment flow and push longer term yields higher. The credit part of 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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