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LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Another month of strong economic data presages another month of lower bond yields, continuing what has become a bond contrarian's dreamscape – 4% on long Treasuries look like a bargain. The bond market has behaved opposite to what one has been trained to expect, but in a world of deflationary forces and quantitative easing, theory won't necessarily translate into reality. Despite US GDP growing at 2.4% yoy, long term real US yields are a miniscule 1%, having reached their trough in the summer at just over ½ %.

We have made the point that we don't think the US will devolve into the deflationary trap that has besieged Japan for the better part of twenty years and seems to now be engulfing Europe. And for the most part, the market agrees, with long term inflation expectations running at around 2% – higher than the current level of inflation of 1.4% yoy according to the PCE Deflator or 1.7% yoy according to CPI; core CPI is running at 1.8% yoy. But the US bond market evidently will not escape some of the effects that we think the economy will. Global investors continue to look to the Treasury market and US dollars as a preferred investment option over depressed European yields and a devalued Euro, which will continue to exert downward pressure on Treasury yields. Government of Canada bonds have benefitted from the path set by Treasuries, albeit to a lesser extent.

With North American bond markets nearing the end of their ultra-low rates environment, at least as we see it, it is not surprising that bond market volatility has increased. This quarter, 10-year US Treasury and Government of Canada yields have traded within 30 and 24 basis point ranges respectively, having twice bounced of lows around 2.15% in the US and 1.9% in Canada. Recall the incredible moves recorded on October 15th when 10-year Treasury and Canada yields moved within 37 and 14 bps ranges respectively, only to finish down 4 and 2 bps respectively (Bloomberg).

Given that short term rates offer little room for decline, the move in longer term yields during November translated into further flattening of both the US and Canadian yield curves. The Government of Canada yield curve has become increasingly flat given the trajectory of Canadian growth and recent inflation data. To put the curve into context, the slope of the 30-2 year yield curve in Canada is 146 bps vs 241 bps in the US. The curve did get to the 120's in mid-2012, but before that once has to look to the period surrounding the credit crisis and *Great Recession*.

Although equity markets continue to chug along, corporate yield spreads seemed to have hit a nadir earlier this year and have generally trended wider since the summer, although stabilising during November. The wider yield spreads offer slightly more protection against further widening of yield spreads, particularly for higher quality credits, whereas the additional protection for lower quality credits has not changed materially.

Outlook & Strategy

Although the Canadian bond market continues to respond to foreign flows, we expect the bond market to eventually respond to the strong economic fundamentals and ultimately to tighter domestic monetary policy. We maintain that the Fed will raise rates sometime in the first half of next year and that looser monetary conditions in Canada coupled with higher-than-expected inflation will lead the Bank of Canada to track the Fed with only limited lag. The portfolio has been positioned with a short duration with optimal yield and roll down characteristics.

We feel that we have surpassed the credit cycle peak, but in the short-term do not expect any significant degradation in credit metrics. However, given the uncertainty embedded in valuation and the reality of poorer market liquidity, we think a more conservative orientation to credit is warranted. We will continue to look for trading opportunities within the credit portfolio.

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