October 31, 2014

Focused Fixed Income

Market Highlights

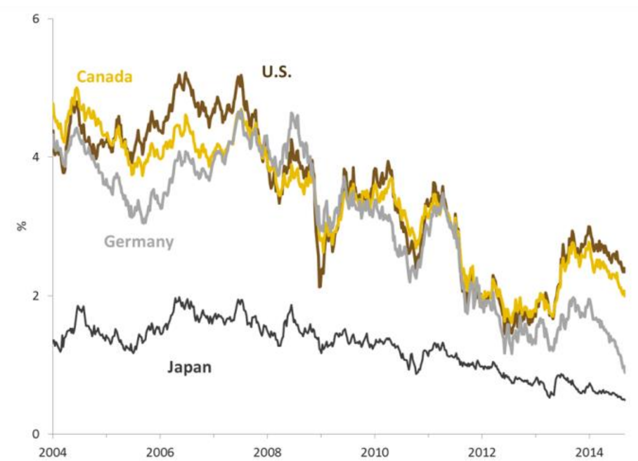
The US bond market and by extension the Canadian bond market spent October vacillating between the forces of so-called global deflation and US recovery. Our take is that, from a US economic perspective, recovery is winning the day and deflation is not-quite global. However, for a variety of reasons, the US bond market has not yet caught up with this optimistic view of the economy. The Federal Reserve continues to manage the rise in Treasury yields employing a broad range of tactics to depress any knee-jerk reaction, on the part of investors, to strong economic data. While the Fed officially dispensed with QE in October (we think the threshold to re-establish QE is relatively high), it continues to use forward guidance and FOMC-member comments to guide yields. (We believe that once the Fed begins to raise interest rates, they will have more difficulty controlling yields through non-market mechanisms.)

Deflationary forces are however alive and well in Japan which continues to be mired in a two-decade low growth/deflationary funk despite the best efforts of Abenomics – it is no surprise that another round of aggressive QE, just announced, has been met with much skepticism. Unfortunately, Europe seems to be headed in the same direction of Japan, having an ill-fated similarity of demographics and an equally ineffectual policy regime. As for the US, we maintain that it will avoid deflation, given the underlying strength of US data that suggest relatively strong growth of between 3-3.5% for the year and inflation that will stay comfortably above 1%. Longer-term, US demographics give reason for more optimism with an overall less-aged population than both Europe and Japan.

Investors have responded to the poor European prospects by pushing European bond yields lower – 10-year Bunds finished the month at 0.84% which was far closer to JGB's at 0.46% than US Treasuries at 2.38% (see chart). Not surprisingly US yields look very attractive under the current scenario, leading investors to migrate to the treasury market and subsequently lowering US yields which fell 17 basis points in October, dragging Canadian yields down by 10 bps. This move was in spite of stronger US economic data including strong manufacturing numbers and continued good employment gains.

In the corporate sector, surging volatility and illiquidity pressured domestic bonds through mid-October followed by some improvement in overall market tone into month-end; the net result was corporate spread widening of 6 basis points for the month. Illiquidity was evident in bid-ask levels (particularly for higher beta issues) which remained strained, a function of both the negative market tone and bank-owned dealers in capital preservation mode heading into fiscal year-end.

Sovereign 10-Year Yields



Source: Bloomberg & Lorica Investment Counsel Inc., as at Sept 2014

Outlook & Strategy

We expect the bond market to continue pricing in tighter monetary policy from both the Federal Reserve and Bank of Canada sometime in the first half of next year and as such will continue to position the portfolio defensively. There has been a significant adjustment to monetary conditions in Canada through the depreciation of the Loonie, and this should give the Bank of Canada more scope to track the Fed's tightening moves more closely.

Owning credit has been a profitable strategy as long as the Fed and a sidelined BoC have been supportive. The question remains as to whether valuations reflect the economy or the implied low level of risk based on stable monetary policy. Given the uncertainty embedded in valuation and the reality of poorer market liquidity, we think a more conservative orientation to credit is warranted. However, we will continue to look for trading opportunities within the credit portfolio.

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