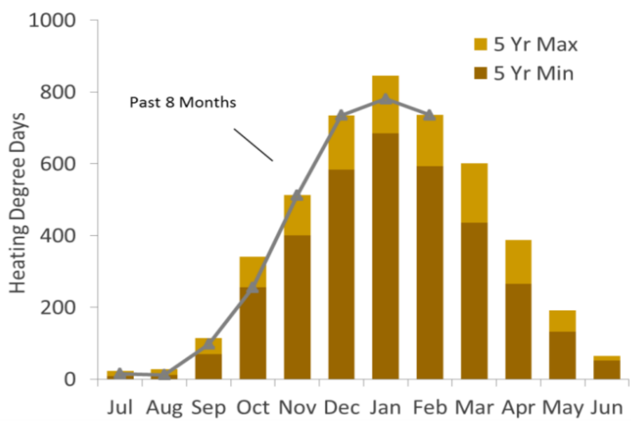
March 31, 2014

What We Think……

Who would've guessed that climatologists would be today's media stars? But every so often, adverse events generate outsized interest in the opinions of a group of experts, who always manage to take to the spotlight no matter how unaccustomed they may be. With climates changing (with no concern for ones political leanings), we all have this need to understand whats going on with the weather and what to expect next? This is of course, doubly true for investors, who try to invest based on what's coming next. Unfortunately, as difficult as weather is to forecast, trying to make investment decisions when the weather is having such a significant impact on the economy is that much more difficult.

Figure 1: Canada's Heating Degree Days



Source: Canadian Gas Association, Environment Canada & Lorica Investment Counsel Inc., as at February 2014.

Although winter 2013/14 is mostly over (somewhat debatable), its impact on the markets is likely not. The weather effects began in December when we saw an above average impact from the unseasonably cold temperatures (See Figure 1) on real GDP which averaged -0.5% MoM. In January, with temperatures returning to the mean, real GDP surprised on the upside, with 0.5% MoM growth. January's weather was not all that bad, relatively speaking, but the weather in February and March was. It would be fair to say that we are not yet beyond weather-impacted data. Q1's official Canadian growth numbers will only be available at the end of May, but more immediate data releases suggest a return to December's levels for February is unlikely. More importantly, given the inability to reliably assess the magnitude of the weather impact, it may not be until we see April's weather-free data, which will be released in May, that we will have an accurate picture of the underlying strength of Canada's economy. The weather impact for parts of the US is similar; but because the impact is diluted across the entire county, with regions of warmer weather, the severity of the weather effect will be more limited.

So beyond the known unknowns (related to the weather) what are the known knowns (not related to the weather) impacting the Canadian economy going forward? Generally speaking, forecasts for growth in Canada have not been high for 2013, based on expectations for a slowing domestic economy and continuing challenges for manufacturing. The mostly negative outlook has been partially offset by hopes for improvement in the US economy, which, while similarly impacted by adverse weather conditions, has shown hints of resurgence. Canadian monetary policy has also been remarkably proactive with a more *growth supportive* policy.

Canada's domestic economy has been underpinned by a strong housing sector for the first half of this decade. However, affordability has declined as the steady rise in house prices has outstripped the decline in mortgage rates and income growth. Consumer finances have, therefore, continued to deteriorate and consumer debt levels are now stubbornly at historical levels. The former finance minister and Bank of Canada governor were both concerned with debt levels, and mortgage rules were changed to try and slow the increase – proving to be somewhat successful. We doubt the new executive will be similarly fixated on the housing sector, but nevertheless, expect consumer finances to improve, albeit slowly. The housing sector will be vulnerable to higher mortgage rates, as we see a material rise in wages as improbable. Other factors affecting the housing market are more difficult to analyse given the dearth of adequate data; these include inter-generational wealth transfer and foreign investment. There is evidence to suggest a moderation in the condo market is at hand, partly due to declining foreign interest. In summary, we view the most likely scenario for housing to be a soft landing with prices stabilising

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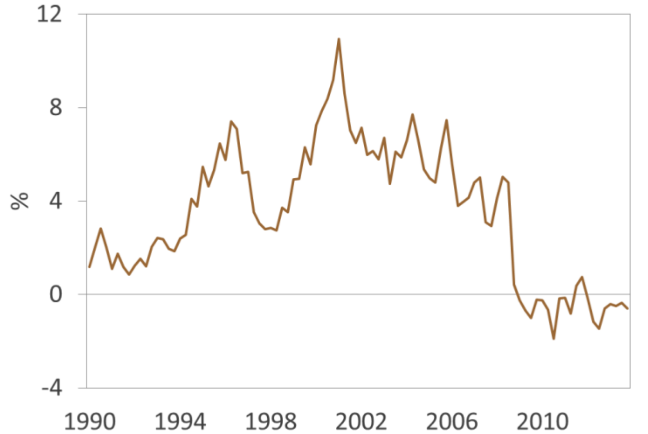
and sales falling to more sustainable levels, and a gradual, but tolerable, rise in mortgage rates.

Figure 2: Canada's Balance of Trade

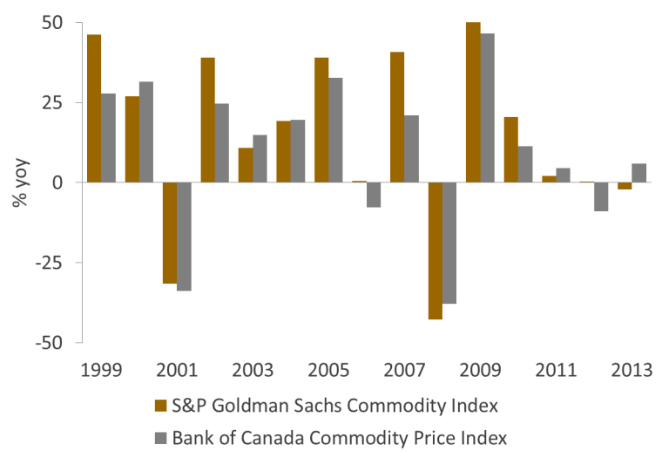


Source: Statistics Canada & Lorica Investment Counsel Inc., as at December 2013.

Coming into the job as governor of the Bank of Canada, Stephen Poloz was expected to pay attention to exports, given his tenure at Export Development Canada. Since the precipitous decline following the credit crisis, Canada's trade balance has stabilised in negative territory (See Figure 2). A key factor contributing to the initial decline in Canada's exports was the rapid fall of commodity prices from the inflated levels in the middle of 2008. More recently, commodity prices have returned to more reasonable levels seen at the end of 2007. Furthermore, Canadian commodity prices have recovered most of the ground lost to US commodity prices in 2012, according to the Bank of Canada Commodity Price Index, in comparison to the S&P Goldman Sachs Commodity Index (See Figure 3). Much of this gain can be attributed to relative improvement in Canadian energy prices. In 2002 manufacturing and commodities made up 74% and 23% of Canadian goods exports respectively, today those numbers are 66% and 26%. While commodity exports have grown, manufacturing exports have declined by 4.6% as a percentage of GDP. The move to lower wage regions in Asia and the lack of productivity improvements have certainly been large factors in the decline, but the appreciation of the Canadian dollar, beginning in 2002, has also not been helpful. So it should not be a surprise that the Bank of Canada has adopted a more proactive monetary policy that has encouraged the depreciation of the Canadian dollar – 7.4% since Poloz's appointment 10 months ago.

Although Canadian core inflation had been below the lower limit of the Bank of Canada's target band since late 2012, policy had not necessarily reflected any real concern on the part of the Bank. With the recent adoption of a more dovish posture and the subsequent depreciation of the Canadian dollar, we have seen core inflation begin, what we expect to be, a rise towards a more comfortable level. However, with core rate now just 1.1% and the terms of trade just starting to improve, there is a long way to go before we expect Governor Poloz to be feeling comfortable.

Figure 3: Commodity Prices – Canada & US



Source: Bloomberg, Bank of Canada & Lorica Investment Counsel Inc., as at March 2014.

For much of the time following the credit crisis, the Canadian economy outperformed the US, owing largely to the relative strength of the domestic economy, led by housing. The stronger growth picture and more solid banking sector, allowed the Bank of Canada to maintain higher short-term rates, avoid quantitative easing, and rely mostly on forward guidance (Governor Carney was an early proponent) to conduct monetary policy. However, strong underlying domestic demand and large foreign flows (See Figure 4) into the Canadian bond market have managed to keep yields of long-term

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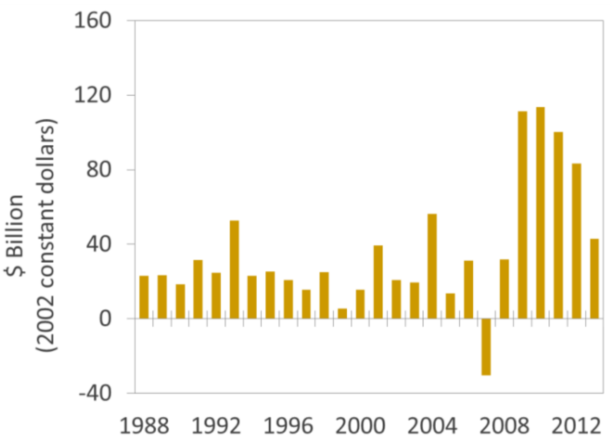
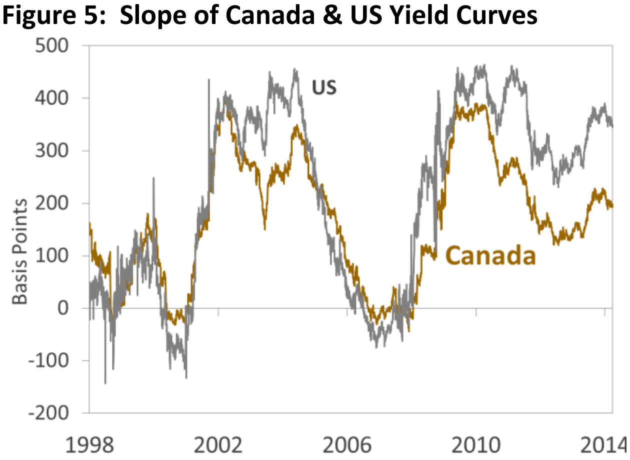
Government of Canada's below those of US Treasuries; the recent shift by the Bank to more of an easing bias, has only added to the discount. Consequently the Government of Canada yield curve has been much shallower than the Treasury yield curve (See Figure 5).

Figure 4: Canadian Foreign Bond Investment



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

Figure 5: Slope of Canada & US Yield Curves



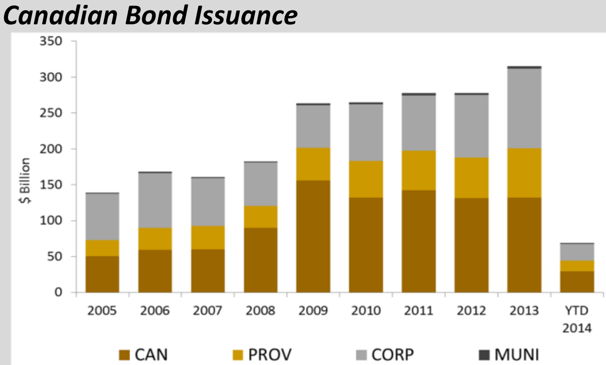
Source: Bank of Canada, Bloomberg & Lorica Investment Counsel Inc., as at March 2014.

The US bond market is still the biggest factor impacting the Canadian bond market and we still believe the next level for US bond yields is higher, notwithstanding the weather and global political uncertainty that have significantly interfered with the path to get there. There was enough good data released in March, despite the weather challenges, to convince us to stay the course on our forecast. However, the Fed has gotten into the habit of trying to control the bond market, and for the time being, Janet Yellen sees the US job situation as still

Asset Allocation to Impact Canadian Bonds

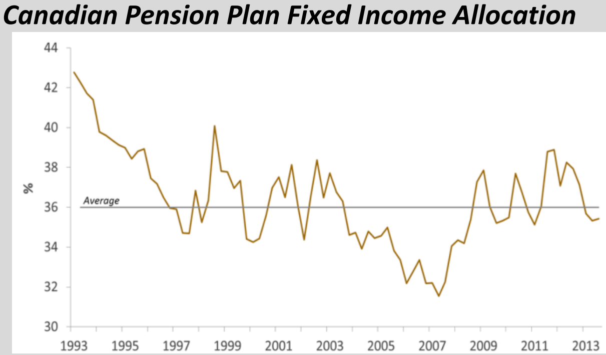
Since 2008 Canadian bond issuance has risen steadily, but so to has investor demand. Initially, there was a significant move by retail investors to reduce their overweight positions in riskier equities and non-performing cash and move into the safety of the bond market, particularly the higher yielding corporate market. More recently, with equities generating huge returns last year, pension funds have sought to rebalance their portfolios by rotating from equities into bonds. Furthermore, this rotation into bonds has, in some cases, had greater net market impact due to the adoption of liability-driven investment (LDI) strategies which effectively requires the purchase of longer duration securities. We expect this move to LDI strategies to continue, albeit at a slow pace.

Canadian Bond Issuance



Source: Bank of Canada, Bloomberg & Lorica Investment Counsel Inc., as at March 2014

Canadian Pension Plan Fixed Income Allocation



Source: Statistics Canada & Lorica Investment Counsel Inc., as at September 2013

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worrisome enough to want to keep yields down. (We have written in the past about how the Fed has moved from managing short-term rates to managing the entire yield curve. Perhaps we should just accept that this is the new world of central banking, but we are sceptical of the Fed's methods. We have already seen some of the faults with QE and how quickly the Fed has backtracked from some approaches to forward guidance.) Given the Fed's modus operandi, we feel that investors will either appear early or be late for the next rise in yields, and that yields will rise in more of a step pattern than a gradual upward shift.

A note on US jobs growth: Despite Fed tapering, US monetary policy remains relatively easy. The improvement in household wealth has benefitted consumer demand and translated into job growth, although to some extent, only for lower paying jobs. The housing market has also improved, but also cannot be relied on for extraordinary job gains. Finally, anecdotal evidence, from reports such as the Beige Book, suggests a growing mismatch between skills and jobs, leaving an excess of unfilled higher paying positions. The US unemployment rate has declined, but the participation rate remains the biggest factor contributing to the decline. Yellen is in the camp that there is still a lot of untapped labour supply, while the other camp thinks a lot of the lost supply is the result of demographic change. We think the unemployment situation will improve slowly, but enough to generate decent economic growth.

Going forward we don't expect the Bank of Canada to make good on their dovish intentions, but rather expect them to keep rates stable, and lag the Fed when rates eventually start to move up, though this is likely some time off. As for long-term Canadian yields, given that investors have, for the most part, digested the Bank's policy shift, we expect them to largely track US long-term yields. This was evident in both the final quarter of last year and the first quarter of this year. There are, of course, areas of the Canadian and US economies that are diverging, but we would expect that improvements in the US will be felt in Canada, although with less of an impact than has historically been the case.

The Corporate Bond Market

For most of the period since 2009, Canadian corporate bonds have outperformed Government of Canada's. Over the last three years the level of corporate outperformance has averaged just over 2% per annum, when comparing mid-term corporates against mid-term governments according to the FTSE TMX Canada Mid-Term Bond Index. Over the most recent 12-month period, the out-performance has been closer to 3% for the same index. For most of 2013, yields spreads were volatile but directionless, and it was only in the last couple of months that we saw sustained spread narrowing, which continued late into Q1 of this year. The average mid-term corporate yield spread versus Canada's is now 122 basis points, just below the narrow end of the trading range of the last four years, but at a level that was last seen in November of 2007.

It is worth noting, that the Mid-Term Index corporate yield spreads hovered around 50 basis points for the better part of three years from January 2004 to January 2007. One could argue that in January 2004 higher credit quality accounted for most of the tighter spread levels – BBB's were just 12% of the corporate weight in the mid-term index, whereas today they account for 47%. However, todays BBB spreads average 144 bps compared to 80-90 bps between January 2004-2007.

For the corporate bond yields to convincingly enter a new lower range, we think we would need to see an environment where corporate balance sheets are sound and investors are willing to continue to finance corporate bonds, without the benefit of non-traditional Fed support. But what does this really mean? QE is on its way out, so neither the implicit easy monetary policy that QE engendered, nor the crowding into riskier assets, can be taken for granted. But we are likely some-time off before forward guidance dissapears, which should provide some support for corporate bonds, although not to the same extent as QE. We think a rise in Canada sovereign yields is likely before the corporate bond market is sustainable at lower yield spread levels. This leaves corporate yield spreads somewhat vulnerable to a move back into the trading range of the last four years. That being said, corporate yield spreads will still provide reasonable protection against spread widening, which we would expect to be limited.