



LORICA | INVESTMENT
COUNSEL INC.

Market Highlights

At the end of April, most market commentators interpreted the Fed's comments from its April meeting as implying that the Fed would be on hold until, at least, September; June, it was felt, was "off the table" and July "too impractical". It would be natural to expect that the bond market would be summarily unresponsive to economic data until the summer months had been mostly worked through. But the Fed's other message of "data dependency" appears to have resonated with investors. Data released at the end of April and the beginning of May indicated prospects for a reasonable rebound from Q1's subpar performance, and economic optimism and some inflation pessimism translated into some bond market nervousness with the US yield curve selling off and steepening. US long bond yields rose from 2.62% (at the beginning of the Fed meeting on April 27th) to peak at 3.08% (on May 13th). The balance of the month saw mostly poor domestic US data, as yields reversed with long bond yields falling to 2.85% at the end of the month. In Canada the move in bond yields was less dramatic, but volatile nonetheless: 30 year bonds went from 2.07% to 2.43% to 2.21%, over the same April 27th to May 29th period.

The Canadian economy has predictably continued to suffer from the decline in oil prices, but the corresponding depreciation of the Looney has resulted in some offsetting improvement in manufacturing exports (according to the RBC Canadian Manufacturing PMI). The changes to the Canadian economy are being felt geographically with Ontario and some maritime provinces leading the way, while Alberta and BC struggle. The most recent communication from the Bank of Canada, suggests that it will remain on hold, while the economy adjusts to the lower oil prices and weaker Canadian dollar. However, we think that Governor Poloz has left enough of an opening in the most recent policy statement (not that he necessarily feels a requirement to do so) to knock another 25 basis points off the overnight rate and weaken the Canadian dollar in the process, should he feel it necessary.

Greece's future continues to play out as sometime Greek Comedy and sometime Greek Tragedy; unfortunately for investors we are still forced to watch. While the magnitude of the impact Greece has on the market is nowhere close to what it once was, less market liquidity means that Greece still accounted for some bond market

Focused Fixed Income

volatility that translated to North American markets last month.

The bond market is undeniably more volatile than any period we can remember (save the Credit Crisis), especially given the lack of real central bank activity, shocking market/economic data or spurious news. We attribute the volatility to poor market liquidity due to a combination of factors including: large price value of a basis point at low yields; distorted market pricing from prolonged central bank intervention; reduced intermediary capacity exacerbated by industry regulation; portfolio concentration due to market growth and consolidation; investor consensus and complacency after a long period of ZIRP; quantitative trading algorithms from high frequency traders, hedge funds, etc.; and dark pools from ETF's and other electronic platforms.

While government markets appeared somewhat vulnerable during the month, the corporate bond market continued to perform well, with spreads all but unchanged during the period. Canadian issuers continued to take advantage of low yields, albeit at a slower pace than in previous years, issuing \$7 billion during the month.

Outlook & Strategy

Investors have begun to factor in the reality of higher yields. While Chair Yellen has continued to hold her cards close to her vest, we believe "data dependency" is the operative catchphrase, and though *what the data has to look like* is not well defined (recall unemployment targets have changed several times), we believe the trigger point is not far off. A September tightening is still in the cards, but it will require a steady dose of stronger data, from now to then – much improved from what we have seen for April. The weather effect and inadequate seasonal adjustments was good for dismissing Q1 growth, but will obviously not suffice for Q2. Firmer energy prices and a levelling off of the dollar should prove helpful. For its part, the Bank of Canada is likely to remain on hold. The portfolio is positioned for a steeper Canadian yield curve.

With yields so low, we expect investors to maintain their interest in credit, so long as there are no signs of economic collapse (a very low probability scenario in our eyes.) We see the biggest risk to the corporate market coming from inadequate liquidity, given the factors mentioned above. We will maintain the overweight in above average quality credits with good liquidity.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager