October 31, 2015

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The capital market volatility that peaked at the end of August and remained elevated for most of September, finally dissipated throughout October. Investors were able to take a break from the confusion wreaked by the Fed, emerging markets and China, and focus on slightly improved domestic fundamentals. Fixed income markets, which had not been spared the volatility, particularly in the higher yielding sectors, regrouped in October and allowed yield spreads to arrest their widening trend. US corporate yield spreads retraced September's widening move, while in Canada, spreads ended the month close to unchanged.

The best performing sector in Canada during the month was provincials, as investors had a chance to rethink the widening move in place since June, which had seen short, mid and long provincial spreads widen by 17, 25 and 30 basis points respectively to their peak in the beginning of October, according to the FTSE TMX Canada Universe Bond Index. Short, mid and long spreads narrowed by 7, 10 and 9 bps respectively, resulting in October returns of 0.13%, 0.16% and -0.12% respectively. Although provincial government fundamentals, led by Ontario's, look challenged, spreads had discounted too much deterioration, particularly with a friendlier partner at the Federal level.

We have commented before on the uncertainty surrounding the Fed's first rate increase and the implication for market volatility, noting that September's surprise pass, was particularly distressful for investors. Economic fundamentals are still giving the Fed a green light, and for the time being capital markets have calmed, allowing the Fed to put itself back in play for December with their October FOMC meeting statement. The bond market has responded with Fed Fund futures now predicting slightly more than a 50% probability of a December rate hike. US and Canadian yields have moved up, with the Canadian yield curve having risen by 5, 7, 10 and 9 bps for 2, 5, 10 and 30-years terms respectively, during October.

New corporate issuance was surprisingly quiet in Canada during October, despite record investment grade issuance south of the border. A total of $6.3 billion came to market in Canada, with significant origination from the banks ($3.7 billion), credit card securitization ($800 million), and project finance ($673 million). November issuance is expected to be more robust as issuers take advantage of any left-over demand and additional demand resulting from December's index extension.

Outlook & Strategy

We have been of the opinion for some time that higher Fed Funds are justified, but begrudgingly accept the Fed's assessment that near-perfect capital market conditions are required for their first move up (our interpretation). Currently, conditions look favourable for a December hike, but we are not willing to put any more than a 50% probability for such a move – any number of factors could disrupt capital markets from now to December's meeting, and further delay a Fed move. We don't expect the front end of the US yield curve to price in much more likelihood of a move, but could see some more steepening of the US yield curve, particularly in the mid-part.

Although the Bank of Canada expressed concerns for the Canadian economy in their October Monetary Policy Report, we don't expect another move from the Bank this year. Instead, we think the Bank will be content to see the Canadian dollar weaken further in conjunction with an eventual move by the Fed. We also expect some discounting by investors for additional Government of Canada supply resulting from a new federal budget. Overall, we anticipate further steepening of the Canadian yield curve.

We still see the best risk/reward in the short-term, high quality area of the corporate bond market, and will continue to overweight the portfolio there. In general, the corporate portion of the portfolio is structured conservatively with good liquidity, and is therefore well positioned to capitalise on relative value and yield enhancement opportunities.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com