July 31, 2016

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Bond yields traded within about a 20 basis points range during July, but ended the month close to unchanged, save for the long-end where yields fell about 10 bps. The decline in long end yields reflects the global decline in high quality bond yields (below zero in many instances) and the corresponding scavenging for yield. Both the US and Canadian long ends represent substantial yield pickup and term premiums versus European and Japanese bonds to investors looking for AAA sovereigns. The flight of capital into North American bond markets was not limited to Treasuries and Canadas – corporates also saw a lot of demand. Canadian provincials, offering a somewhat unique combination of quality, long duration and yield pickup were also sought after by foreign investors.

The Canadian corporate market was hit with a July record of $12.3 Billion in new issuance. Investors were able to easily digest the supply, narrowing corporate spreads by an average of about 5 bps. Provincial issuance was also substantial, totaling $6.4 Billion, with $2.9 Billion coming in the long end – long provincial spreads narrowed by 6 bps. While foreign interest in July is anecdotal at this point, International Fund Flows released in July for May indicated concrete demand for Canadian bonds by foreign investors. In fact, May's sales to foreigners were $17 Billion, surpassing March and April's totals combined. However, on a year-to-date basis, foreign demand for Canadian bonds is still down versus a year ago by about $8 Billion, perhaps reflecting earlier concerns over the C$ and potential for higher yields on the back of Fed increases. Domestic investors have also been enthusiastic about long bonds, as indicated by the flows into bond mutual funds and ETFS. For example, year-to-date, flows into Canadian long bond ETF's were $620 million, while flows into overall Fixed Income ETF's were $4.9 Billion.

July's flattening of the US and Canadian yield curves were driven by long end declines with little movement from short-term rates. The market is hardly bullish on the possibility of a Fed increase until the end of the year, with Fed Fund futures giving one in four chances of a rate rise at either the September or November meetings and only a near 50% probability at the December meeting. While North American monetary policy is effectively on hold, Europe continues to actively engage in QE, Japan is flirting with "helicopter drops" and the UK has lowered rates and restarted bond purchases. German and Japanese yields are negative all the way out to 10-years with much of the Eurozone below zero up to seven years; the entire Swiss yield curve is below zero.

With bond yields so low, issuers and bond math have conspired to lengthen market durations – index durations are 6.3, 7.4, 7.8 and 9.5 years for US Treasuries, Government of Canada's, Eurozone sovereign bonds and JGB's respectively, according to Bloomberg Bond Indices. Yield declines and long durations have consequently combined to generate significant capital gains year-to-date - 5.0, 2.9, 6.1 and 6.0 percent for Treasury, Canada's, Eurozone sovereigns and Japan respectively, leading to year-to-date total returns of 5.8, 3.5, 6.4 and 6.1 percent respectively.

Outlook & Strategy

We are not expecting any imminent movement from either the Fed or the Bank of Canada. While the Fed is less constrained by underlying economic data, uncertainty emanating from foreign markets, policies, and, perhaps more importantly, its inability to temper investor proactivity to genuine rate increase signals are still holding it back. The Bank of Canada will be content to watch fiscal policy unfold and look for some bounce on the back of a rebuild in Fort McMurray.

The long ends of the Canadian and US yield curves have already had significant responses to declining rate structures in Europe and Japan. We expect yields to continue to be volatile, but do not expect to see further sustained declines. Although North American economies have slowed, there are still significant areas that should sustain economic growth and inflation at reasonable levels.

We will maintain a relatively shorter duration with an overweight in corporate bonds and look for relative value and trading opportunities.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

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