June 30, 2011

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

As the first quarter turned over, it was as if investors collectively put on their 3D glasses and the world view came into focus. The 3 and 6 month Universe index returns to the end of Q1 were -0.27% and -0.98% respectively, in contrast with the next 3 months during which the index returned 2.5%. Perhaps more descriptive were the returns for Government of Canadas which were -0.59%, -0.17% and 2.16% over the same periods. Q2 was a clear case of risk-off in the capital markets and bond investors bought up better quality sovereign debt at the expense of other asset classes including, to a limited degree, corporate bonds. Yield spreads for short, mid and long corporate bonds widened by 8, 14 and 7 basis points respectively over the quarter according to the DEX Indices.

Coming into focus was the reality of a stimulus-depleted U.S. economy – a series of weaker-than-expected employment and manufacturing data were too much for optimistic investors to overlook. Next the looming European sovereign debt problems came into focus, as time was running out on a short-term resolution to Greece's financing requirements. Both situations demanded investor attention and revaluation. Both situations are fluid and will likely result in continued market volatility, especially as policy responses are in play. To the very end of the quarter, changes in the Greek crisis resulted Canadian 10-year yields rising by 25 basis points.

Across the yield curve, the best corporate spread performance was reserved for defensive sectors: utilities, infrastructure, pipelines, and instruments: short and mid-term bank covered and deposit notes. Worst yield spread performers included media (YPG), telecom and cable (overhang of heavy issuance), retail (margin compression, foreign entrants and all constituents are BBB rated), and mid and long-term tier 1 hybrids (high beta and lingering par call concerns).

Portfolio Activity

May 5 – Sold a position in CMB 3.55/13 and increased the weight in Canada 3.75/19. This increased portfolio duration relative to benchmark via an overweight in short 10-years. By doing so, we increased our bias to yield curve flattening, while maximizing yield pick-up.

June 2 – Established position in Can 3.25/21 and invested June 1 coupon flows while also decreasing weight in Can 3.75/19. We maintained long duration exposure relative to index post June 1 extension. Roll of eight year debt to benchmark ten year in anticipation of flattening.

June 13 – Further reduced position in Can 3.75/19 and increased weight in Can 3.25/21. Maintained long duration exposure relative to the index in light of index extension.

What Worked In The Quarter

From a duration perspective, the portfolio was well positioned during the quarter with a slightly longer duration, and overweight in the seven and ten year parts of the yield curve, the best performing area.

The portfolio was also reasonably well positioned from a sector perspective with an underweight (on a duration basis) in defensive corporate bonds, amidst a widening of corporate yield spreads, an average of 10 basis points across the yield curve.

The portfolio has a higher running yield (3.18% vs. 3.04%) versus the index as a result of the portfolio's concentration in 10 year bonds and overweight (% basis) of corporate, provincial and municipal credit.

What Didn't Work In The Quarter

The overweight position in provincial bonds slightly offset the underweight in corporates; although the higher quality provincial sector experienced materially less spread widening – 3 basis points on average during the quarter.

Outlook & Strategy

We expect weak U.S. GDP in the second half of 2011 and 2012, and a Canadian economy that will not be as resilient as in the last few years. The strong housing market of the past is unlikely to provide the same made-in-Canada offset this year.

A divided Fed will ensure an end to quantitative easing in the summer; but we don't expect rate hikes this year. Nor do we expect any adverse impact to bond yields. Despite recent Canadian inflation data that has surprised to the upside, we remain committed to our view that the Bank of Canada will remain on the sidelines until late Q4 at the earliest.

Bond yields will continue to stay low with the caveat that policy decisions will also continue to provide volatility but little directionality. The steepness of the yield curve offers an opportunity to pick-up yield.

We remain more cautious than most over the prospects for risk assets including equities and corporate debt. Downward revisions for growth and sovereign debt problems will challenge investor risk tolerance.

From a domestic perspective, corporate bond market returns will be more impacted by supply, regulatory events and exogenous events, than a significant degradation in the general quality of credits.

At current spread levels and a saturated investor and dealer base, we feel there is little catalyst for significant spread tightening. The insatiable appetite for credit as of late has likely been met and if the near record levels of supply continue, spreads will be materially pressured.

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