LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Amidst all the economic and market gloom of the third quarter, bonds offered some respite as yields fell in all but the riskiest sectors. The DEX Universe index yield fell 63 basis points, producing a Q3 return of 5.12%, to add to the healthy 2.2% from the first half of the year. Canada's were the best performers, as 5, 10 and 30-year bonds fell 94, 97 and 78 bps respectively. Provincial and corporate bonds underperformed (in that order), although faring better than their global counterparts. The DEX mid-term (5-10 years) provincial and corporate indices lagged the mid-term Canada index by 1.55% and 3.4% respectively (although some of the corporate index underperformance was due to its shorter duration).

Investors, who had become accustomed to the predictable so-called risk-on/risk-off trade of the last several years, were helpless in Q3, as the only trade during the quarter was risk-off. Readers may remember the end of Q2 when risky assets rebounded at the end of the quarter. No such antidote was on offer this quarter, as the depth of despair coming from the U.S. economy and the Eurozone crisis was just too great to generate any momentum behind risk assets.

Although the S&P downgrade received a lot of publicity, we would argue there was no pivotal event that zapped the markets during the quarter, just a string of bad news. Europe's sovereign debt crisis has shown incredible resiliency in terms of its ability to drag on without resolution; and the sheer number of decision-makers involved in the crisis has ensured a roller-coaster of sentiment, but with a general trend to deterioration. In the U.S., the economic data has steadily gotten worse, as have the prospects for further supportive monetary and fiscal policies; and the Fed's Operation Twist has widely been dismissed as having limited prospects of economic benefit.

Although yield spreads of corporate bonds were under pressure during the quarter, the large drop in government yields ensured that corporate bond returns were decent in all but the riskiest of credits. In the Canadian market, corporates gained further support from the Canadian market's typical isolationist behaviour – spreads were far more resilient than those seen in the U.S. or Europe. For example Canadian 10-year deposit notes spreads widened by about 33 bps versus 137 and 110 for senior bank debt in the U.S. and Europe respectively.

Portfolio Activity

Aug.: Established position in Ontario 4/21 and sold GTAA 6.25/12's - increased portfolio duration and provincial weight. Increased position in Canada 3.25/21 and reduced weight in 407 Intl 4.65/12 - index extension.

Sep.: Established position in Canada 1.5/12 and reduced position held Canada 3.25/21 - duration brought to neutral. Increased position in Canada 3.25/21 and reduced position in 407 Intl 4.65/12 – Maintained neutral duration.

What Worked In The Quarter

The quarter was a good one for the portfolio which was well positioned for the rally, with a ½ year long duration concentrated in the ten-year part of the yield curve. In addition the relatively defensive position in credit – more provincials than corporates (on a risk weighted basis), and more high quality corporates also benefited performance.

What Didn't Work In The Quarter

Provincial overweight was a negative for performance.

Outlook & Strategy

Bonds have had a good run so far this year, but we hesitate to extrapolate the performance into the next quarter. Investors have headed for the cover of government bonds while dumping riskier assets. There still may be some migration left, but we think that lower bond yields from here, will only be transitory. On the other hand we do not see justification for higher yields, so we think that there will be a continuation of the volatility around current levels and an opportunity for nimble trading.

A wild card will be declining inflation or deflation: a strong U.S. dollar may be the catalyst for such a decline, resulting in another secular downward move in yields. Although Canadian inflation may lag such an inflation move in the U.S. – a weak C$ could push our inflation the other way, at least in the short run; Canadian yields would eventually follow U.S. yields down. Think the Japanese yield curve!

Although risky assets have gotten beaten up over the last six months, we don't think the bashing is completely over. We have been defensive where credit is concerned, and while tempted to change course, we have chosen to remain on the sidelines for now. We believe many domestic investors are still sitting with troubled long credit positions, and it will be interesting to see if there is some level of equity deterioration that will finally translates into credit liquidation. We will continue to look for the right opportunity to increase the credit risk of the portfolio.