June 30, 2012

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The second quarter was a good one for bonds, delivering a performance somewhat reminiscent of the rallies of 2010 and 2011, albeit one quarter early. The DEX Universe bond index returned 2.25% after a relatively disappointing Q1 at -0.21%. Ten-year government of Canada yields ended the quarter at 1.74%, down 20 basis points from the level at the beginning of the year, after falling to an all-time low of 1.63% on June 1. Ten-year U.S. treasuries also fell to an all-time low of 1.45% on the same day. Although it was a volatile quarter for risky assets, corporate bonds faired reasonably well, all things considered, with the DEX Universe Corporate Index returning 1.76%, compared to provincials at 2.80% and Canada's at 2.46%.

During the quarter investors were hit with a barrage of weak economic data, and the reappearance of Eurozone problems which quickly erased the first quarter optimism related to exaggerated U.S. recovery prospects. U.S. payrolls were the biggest disappointment, averaging a paltry 75,000 new jobs per month for Q2, with the weak retail numbers just serving to reinforce the fledgling state of the economy. Commodity prices were also weak; with energy prices notably falling by 17.1% (according to the energy component of the S&P Goldman Sachs Commodity Index). The one bright spot was improvement in the U.S. housing sector, although not observed uniformly across all segments and regions.

Problems in the Eurozone hit the headlines once again, this time Spain and Spanish banks being the dominant concern. Investors were perhaps surprised more by the timing than anything else; but the markets behaved in similar fashion to previous Eurozone episodes with volatile risky asset prices – the VIX index ended the quarter at 17.08 after reaching a quarterly high of 26.66 on June 1. Canadian corporate spreads were sufficiently wide to insulate investors from the spread widening which was limited by the inherent demand for domestic spread product and the generally poor liquidity of the corporate sector.

Although the economic data was generally negative from a risky asset perspective (the S&P/TSX and S&P 500 were down 5.67% and 2.75% in local terms, respectively), performance would have been worse, had it not been for investor expectations of further Fed intervention. For its part, the Bank of Canada's June policy statement was widely viewed as backing away from earlier indications of imminent tightening.

Portfolio Activity

Senior bank debt came under increased pressure (liquid credit proxy and supply). The opportunity was taken to purchase CIBC 3.95% 14-Jun-17 and Royal Bank 2.58% 13-Apr-17. Positions in Can 2.75% 1-Jun-22 and Can 2% 1-Sep-12 were reduced.

Similarly, telecom and cable spreads underperformed (supply pressures) yet fundamentally still provided attractive relative value. Positions in Telus 4.95% 15-Mar-17, Rogers 3% 6-Jun-17 and BCE 3.35% 18-Jun-19 were established. Positions in Can 2.75% 1-Jun-22, Can 2% 1-Sep-12 and GE 4.375/12 were reduced. Duration was increased.

The corporate trades were largely implemented near the widest credit spread levels of the quarter and moved the portfolio from being underweight corporates on a duration weighted basis to overweight.

What Worked In The Quarter

The portfolio was slightly long duration for much of the quarter. The overweight was focused in the 10-year part of the yield curve which outperformed 2 and 30-year yields by 23 bps and 12 bps respectively over the period.

Our more defensive position vis-à-vis corporate credit was a positive for performance as corporate yield spreads widened significantly during the quarter.

What Didn't Work In The Quarter

The portfolio was overweight long provincial credit and with the pullback in risk, long provincials underperformed federal government issues. This negative relative performance was partially offset by the portfolios mid-term provincial positions which outperformed all other sectors.

Outlook

We continue to believe that bond yields will remain low over the medium term. The ebb and flow of markets, on the back of floundering economic data and an unresolved Eurozone situation, will continue to create volatility, but not result in an appreciable trend in yields. We expect the U.S. election and fiscal policy to only add to the volatility.

In our view, Chairman Bernanke is predisposed to more non-traditional monetary policy stimulus, and will draw the conclusion that circumstances warrant it. Given the recent rally in mid and long-term yields, we think the preference will be for some action that targets credit spreads, perhaps through mortgage securities. Complicating matters is the little issue of a Presidential election in November which should impact the timing of any Fed action – therefore look for a move in the summer. At home, weaker commodity prices and an exposed housing sector, could very well pave the path for easier monetary policy from the Bank of Canada.

The corporate bond market will continue to be impacted more so by exogenous events and supply than corporate fundamentals, which in terms of leverage, liquidity and profitability remain sound. In the near term we do not expect any significant degradation in the general quality of credit or any significant deviation from conservative corporate policies.

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