LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

After getting off to a terrible start in January, the Canadian bond market rebounded in February and March, erasing losses in all but the long end of the government sectors. Overall returns for the quarter, according to the DEX Universe Index, were a respectable 0.69%, albeit divided unevenly between corporates: 1.52% and governments: 0.37%. Long governments were the big losers, with the average Canadian and Provincial long bond (~20 year term) yield rising by 7 and 8 basis points respectively during the quarter while yields in the rest of the Universe fell over the same period.

Consistent with our expectations, the Canadian yield curve steepened relative to the U.S. yield curve, as investors began to reconsider expectations of an increase in interest rates by the Bank of Canada. Thirty-year bond yields generally tracked the U.S., rising 14 bps, while five and ten year yields fell by 8 and 4 bps respectively (versus rises of 5 and 9 bps respectively in the U.S.), rendering the mid area of the yield curve the optimal term in the Canadian bond market in Q1.

The behaviour of the US Treasury market in the quarter was consistent with an economy that is only begrudgingly showing signs of improvement amidst a rates environment that has been constrained by the Fed's QE programs. At the same time, these QE programs and the Feds forward guidance have encouraged risk taking across capital markets which has spurred activity and driven returns in the corporate bond market.

Although we did not see moderation of politically inspired market crisis to start 2013, we did see a moderation of market response. While the Fiscal Cliff was a significant concern for the markets last year, Sequestration was all but ignored in Q1. And while the on-again/off-again Eurozone crisis did rear its ugly head – this time in the form of the Cypriot banking crisis; this latest episode did not translate into the typical risk-on/risk-off behaviour seen in the past. U.S. treasuries did rally in a flight to safety, dragging Canada's along for the ride, but the stock market was undeterred in its march to new highs.

Portfolio Activity

Feeling that mid and long-term yields were at the higher end of their trading range, we took the opportunity to lengthen the duration of the portfolio in anticipation of yields falling. A position in Canada 4.0%/2041 was established and the position in Canada 2.75%/2022 was reduced. As yields fell to the middle of our forecasted range in March we reduced our long relative duration exposure, but increased our overweight in the middle of the curve in anticipation of further curve steepening. Positions in Canada 4.0%/2041 and Canada 2.75%/2022 were sold and Canada 1.5%/2023 was purchased.

What Work In The Quarter

The portfolio was long duration relative to the index as bonds rallied. Additionally, the portfolio was bulleted in the 10 year area of the curve (in lieu of long bonds) which outperformed as the long end of the yield curve steepened.

The portfolio was overweight corporates relative to the index, concentrated in higher yielding and higher beta short and midterm financial and telecom/cable issues.

A long position was also held in provincials, where the extra yield carry and average spread tightening (3-5 basis points) contributed positively to performance.

What Didn't Work In The Quarter

The increased portfolio duration In February via a move from 10's to long bonds, only captured a small portion of the rally in yields as long bonds significantly underperformed during the rally.

Outlook

The Canadian bond market has begun 2013 consistent with our expectations for a steepening of the yield curve via lower short term yields with no significant trend in longer term yields, amidst a reasonable amount of volatility. We believe there is room for the yield curve to steepen further – Canada's economic data will likely continue to disappoint. We should also see more market volatility – a combination of mixed U.S. economic data, political crisis and monetary policy intervention should prevent yields from rising significantly. That being said, we are not big fans of long bonds at this juncture and have reduced our exposure to that part of the yield curve. Overall we will continue to position for changes to the yield curve.

As far as credit goes, we are comfortable with our over-weight, albeit it's more conservative makeup. As long as the Fed continues to support risky assets through QE, we feel credit markets will remain relatively stable. However, yield spreads have moved a long way and interest in corporates is at an extreme – any change in investor sentiment could have a noticeable impact on spreads. We will continue to look for relative value trades.

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