LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The second quarter was the worst bond market quarter in Canada since Q2 1994. Bond yields started rising following the better-than-expected US Non-Farm Payrolls report for April, but then really got going with the help of the Fed and their clumsily delivered message that they would begin exiting from their open-ended quantitative easing policy (QE3) later this year; assuming their employment and inflation forecasts were broadly correct. In performance terms the DEX Universe Index and Merrill Lynch Broad Market Index returned -2.36% and -2.44% respectively for the quarter. In Canada, corporates and provincials outperformed Canada's (-2.69% and -2.64% vs -3.25% respectively according to the DEX Mid Term Index) while in the US, corporates underperformed Treasuries (-4.13% vs -3.45% according to the Merrill Lynch 5-10 Year Indices).

The Fed was successful in removing some of the speculative froth, arguably that they had created, from riskier assets – for example, high yield bonds and emerging market equities fell 3.1% and 8.9% respectively in the quarter. However, they also sparked an unexpected run-up in real yields (10-Year TIPS and RRB's rose 113 and 92 bps respectively in Q2) that drove yield curves steeper and sovereign yields higher – 10-Year Treasuries and Canada's rose by 64 and 57 basis points respectively, over the same time period.

Portfolio Activity

Yields were volatile over the quarter, but directionally headed higher, and adjustments were made to the duration of the portfolio. A number of provincial and federal positions were purchased and sold. Additionally, we took the opportunity to slightly increase our corporate weighting on the back of corporate spread widening.

What Worked In The Quarter

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

The portfolio was also overweight corporates relative to the index. Corporate spreads widened by 5 basis points on average however the additional yield carry more than offset this widening.

What Didn't Work In The Quarter

The portfolios overweight in the middle part of the yield curve accounted for most of the drag in performance as 10-year yields rose by 22 bps more than 30-year yields during May and June.

Outlook

The Fed's projections (released following the most recent FOMC meeting on June 19) are for lower unemployment (falling to approximately 7% by June 2014) and low (below 1.5%), but transitory, inflation. Household consumption, driven by the growth in household wealth due to higher house and asset prices (equities are still up 13.8% for the year), and the housing market will likely have enough momentum to generate the employment gains necessary for the Fed to initiate their planned exit from QE3 in Q3. We expect investors to demand more compensation for taking on duration risk in light of Fed's forward guidance that is now pointing up. To The extent that monetary stimulus is a combination of asset purchases and low short-term rates, policy will still remain accommodative despite a tapering in Fed purchases; Treasury issuance is expected to decline for the remainder of this year. However, higher long term yields and spreads, which have pressured mortgage rates higher, will likely have a detrimental impact on consumption and the housing market. Add in the impact of weaker global growth and sequestration and we wonder if further down the road, growth may not disappoint.

We have shortened the duration of the portfolio to 4.8 years which is 2 years shorter than the benchmark duration, with the exposure being removed roughly equally from the 10 and 30-year term buckets. We anticipate the yield curve to steepen by at least an additional 50 basis points by year-end, with the middle of the yield curve likely generating further underperformance. The portfolio structure should insulate the portfolio from the worst of any further back-up in yields. Although corporate yield spreads have not widened in Canada, we are concerned spreads could be impacted by a rise in yields – the portfolio is overweight corporates with more defensive names.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

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