LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Q3 has been quite the Fed propelled roller coaster. Just when investors thought they were making sense of Fed communication, Bernanke once again changed the game plan by changing the unemployment targets and disappointing the majority of investors who were expecting a September reduction of asset purchases. However, it is important to note that bond yields have only retraced half of the move that began mid-way through Q2 and as such reflect investor expectations of an eventual end to the QE program, or at least the start of tapering. Also, risk assets look a little more risky to investors now that QE tapering is on the table and yield spreads are consequently wider (which we would deem to be a significant part of what Bernanke aimed to accomplish with introduction of taper talk in the first place).

Canada bonds took their lead from Treasuries during the quarter, although with slightly less volatility: 10 years traded in a 46 basis points range, from a low of 2.36% to a high of 2.82%. Short term rates were relatively stable, with the bulk of the move experienced in 5-year bonds and longer. Investors have accepted the Fed's forward guidance that short term rates will not move until at least 2015 (updated at Bernanke's September's post-Fed meeting press conference). Canadian OIS are now pricing in that overnight rates will remain unchanged until at least the end of 2014 with a 2/3rds probability.

Income was enough to offset the small rise in yields and deliver slightly positive bond returns for Q3, according to the DEX Universe Index (0.11%). Corporate bonds were the best performer in the quarter, marginally outperforming provincials on a duration adjusted basis (mid-term corporates returned 0.64% vs. provincials at 0.52%). Also, the yield pickup on credit was enough to offset the small amount of spread widening during the period.

Portfolio Activity

The portfolio was optimally structured on a yield curve and sector basis relative to our interest rate and sector forecasts, thus trading was limited.

What Worked In The Quarter

The portfolio is structured with a short duration via a concentration in two year area of the yield curve in lieu of maturities 10 years and longer. With the prospect of Fed tapering on the horizon, mid and longer term rates (>5 years) moved higher, whereas shorter-term rates held steady. For the quarter 5, 10 and 30 year yields rose by 6, 10, and 17 basis points respectively, whereas 2 year yields fell by 4 bps. The portfolio outperformed on this bear steepening move of the yield curve.

Corporate exposure relative to the index was neutral on duration weighted basis with a concentration in higher yielding short-term financials. Significant foreign issuance from domestic banks eased supply concerns and shorter-term financials outperformed. The portfolio also lacked exposure to underperforming sectors such as real estate and retail

What Didn't Work In The Quarter

The portfolio's duration and credit exposure were more defensive and conservative than the benchmark resulting in an overall lower yield.

Outlook & Strategy

Despite the confusion coming from Bernanke and the rest of the FOMC, we are confident in our belief that the Fed cannot continue asset purchases indefinitely, nor can it continue to justify its QE program on the basis of the ambiguous results seen to date. We think September's tapering head fake was based on the eventual government shut down and the risk that commencing tapering would drive yields up by another 50 basis points and do irreparable damage to the consumer via higher mortgage rates and lower asset values. We expect that tapering will still likely start this year and continue at a pace that will push the yield curve steeper. Ten-year yields should rise back to pre-September Fed levels. As for the shorter-end of the yield curve we don't believe the Fed will be comfortable raising rates until beyond next year. However, we only see longer term yields collapsing in the absence of QE if deflationary expectations rise, something we don't foresee happening. We have reduced the duration of the portfolio to about 4.6 years which is 2 years short of the benchmark duration. We will look for additional opportunities to adjust the duration distribution of the portfolio to increase the overall yield of the portfolio and take advantage of any move in market yields. Credit spreads are also vulnerable to a reduction of QE, and hence we will continue to remain overweight but in more defensive issues.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

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