LORICA | INVESTMENT COUNSEL INC.

# What We Think……

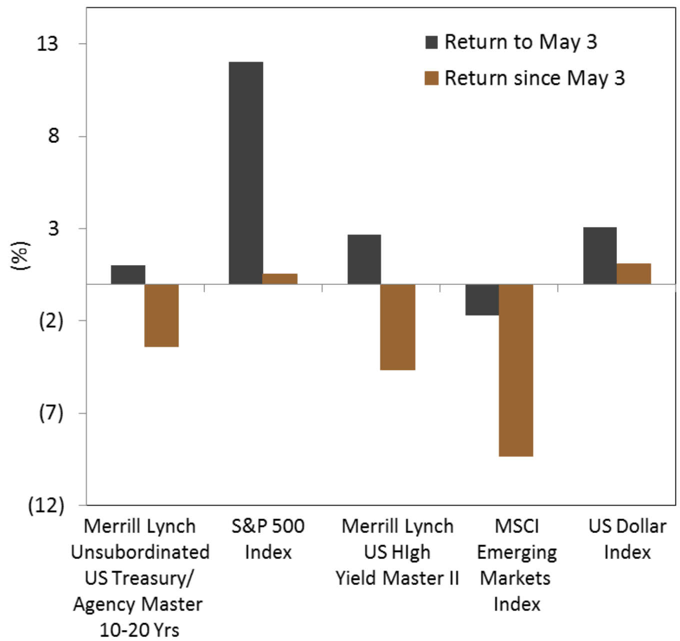
## *Are bond yields in a secular rise?*

The questions facing bond investors are: is this the beginning of a secular rise in bond yields; have bond yields greatly over-reacted to the Fed; or are we somewhere in between? The current run-up in bond yields began May 3rd with the release of April's US employment report which took investors by surprise, reporting a gain of 165,000 new jobs and significant revisions of a combined +110,000 for March and February. The sell-off gathered momentum with rumours that surfaced around May 9th that the Fed would begin tapering bond purchases and culminated with a dramatic rise in yields, following Bernanke's press conference and the release of the FOMC statement on June 19th.

Ever since investors got hints of a post-QE3 world, there has been nothing but market volatility, which has not been confined to US Treasuries. (See Figure 1.) From the first rumours that John Hilsenrath of the Wall Street Journal (Bernanke's then thought-to-be chosen mouthpiece) would be writing a story about Fed tapering, to days following the press conference, 10-year US Treasuries rose by 80 basis points to a high of 2.61%. (Canada's rose by 74 bps to a high of 2.54%.) The rise has been rapid and dramatic and investors and Fed officials have been clearly caught off-guard, so-much-so that certain investors and Fed officials have been trying to talk yields back down. In fact, since the press conference, there have been five FOMC members (Dudley, Lockhart, Powell, Stein and Williams) who have stated publically that market participants had over-reacted to Bernanke's comments. There has been a rebound in yields, but it has been relatively minor.

Under Bernanke, the Fed has strived for transparency and member independence, which have come with mixed results. While the Fed has wanted the market to embrace its easy monetary policy agenda over a longer time-frame, it has used transparency and forward guidance as an effective way of advancing its agenda. However, as the Fed has begun a retreat from the status quo, it is finding that the markets reliance on its transparency is becoming more of a burden to effective policy. Moreover, member independence has sometimes clouded the Fed's message by misleading some investors into overweighting dissenting voices, and thus questioning the conviction and continuity of Fed policy. And finally, the fact that the Fed's unconventional policies do not have any precedence almost ensures market volatility, especially as the Fed initiates a reversal of its accomodation.

**Figure 1: 2013 Asset Returns Before and After May 3rd**




*Source: S&P, Bloomberg, Bank of America Merrill Lych, MSCI & Lorica Investment Counsel; as at June 2013*.

We believe the current quantitative easing program (QE3) was instituted by the Fed as an insurance policy against recession and deflation amidst an environment of disappointing economic data. Most importantly, unlike the earlier QE programs, QE3 was open-ended such that it could be used in conjunction with forward

LORICA | INVESTMENT COUNSEL INC.

guidance to more effectively flatten the yield curve and keep longer term bond yields lower than would otherwise be the case. In our view, **it has not been so much the actual volume of Treasuries and MBS purchased that had been keeping bond yields lower, but rather the guidance that these purchases would continue with no precise end-date.** Investors had ultimately become comfortable owning longer duration Treasuries and a whole host of riskier assets. Of course the problem for the Fed and its open-ended QE3 was always *how would they exit the program in an orderly and graceful manner.* We had expected that the Fed would choose to more-or-less follow the market's lead on the exit, allowing investors to respond to improving economic data by gradually raising yields – this may have been wishful thinking? (Yes, there once was a time when central banks worried mostly about short-term rates and left longer term yields to investors.) Instead, the Fed has been somewhat doctrinaire in its approach to transparency (likely a product of Bernanke's academic pedigree) outlining a probable time-frame for removing QE3, and encouraging the backup of bond yields in the process – a situation the Fed is clearly unhappy with, especially given the tenuousness of the recovery to this point.

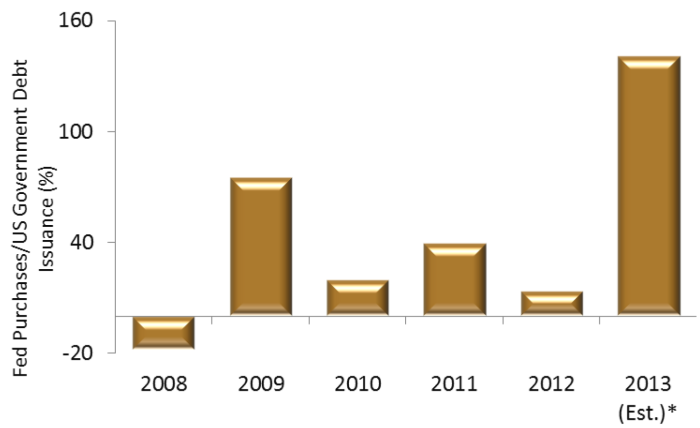
**Figure 2: FOMC Economic Projections – June 2013**

| Economic Indicator | Central Tendency | | |
|---|---|---|---|
| | 2013 | 2014 | 2015 |
| GDP Growth | 2.3 - 2.6 | 3.0 - 3.5 | 2.9 - 3.6 |
| Unemployment Rate | 7.2 - 7.3 | 6.5 - 6.8 | 5.8 - 6.2 |
| Core PCE Inflation | 1.2 - 1.3 | 1.5 - 1.8 | 1.7 - 2.0 |

*Source: Federal Reserve & Lorica Investment Counsel; as at June 2013*.

So what is the Fed's current policy and why? During Bernanke's term, the Fed has gone out of its way to define policy objectives surrounding its dual mandate of inflation and growth – firm targets of 2% for inflation (the Fed prefers the Personal Consumption Expenditures or PCE Deflator) and 6.5% for the unemployment rate are now understood as policy goals. At the recent press conference Bernanke surprised many by relating the Fed's growth, employment and inflation outlook (see Figure 2) to a scheduled removal of QE3. If the Fed is correct with its forecast (admittedly, a big "IF"), investors should expect no further asset purchases by midyear 2014. It is true QE stimulus is not about to stop right-away (see Figure 3), and the Fed emphasized it will respond to disappointing data, but the essence remains that guidance is now for a tightening in monetary policy. Not surprisingly investors have steepened the yield curve, and are demanding greater compensation for owning longer duration bonds.

**Figure 3: Fed Purchases as a Percentage of Issuance**




** Based on Lorica's estimates of Federal Reserve purchases for 2013 assuming a linear tapering from September 2013 to June 2014 and US government debt issuance projections from the Congressional Budget Office for 2013*

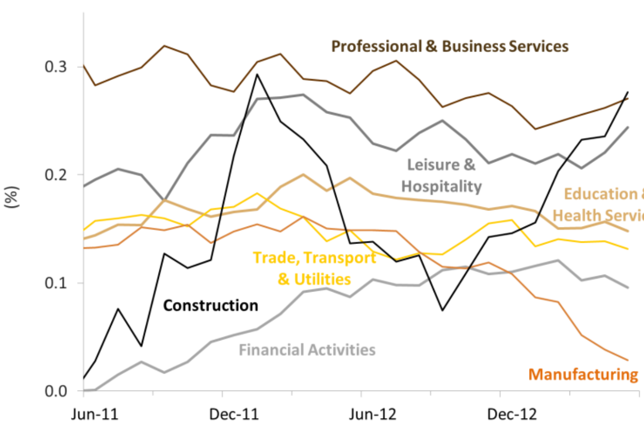
*Source: Federal Reserve, US Treasury Department, Congressional Budget Office & Lorica Investment Counsel; as at June 2013*.

While some FOMC members and high profile bond investors have been very critical about the market's response to QE exit, it has been for very different reasons. Most FOMC members are comfortable with the Fed's economic outlook, but believe investors have over-reacted by pricing-in stimulus to disappear immediately; and have suggested that a more gradual rise of yields is appropriate. In contrast, some

LORICA | INVESTMENT COUNSEL INC.

investors believe that the Fed's economic outlook is overly optimistic, especially in light of higher bond yields, and that the Fed will ultimately continue with its asset purchases, thus driving yields back down. To the extent that lower long term yields have been more about guidance than actual purchases, the planned QE exit by the Fed is unquestionably guiding the market in a new direction. We believe, that until investors have reason to expect the Fed to deviate from its new course, the direction for long-term yields is up. However, we also believe that that a rise in short-term yields is quite a ways off and therefore the rise in long-term yields will be limited by the slope of the yield curve. The overnight-10's yield curves in the US and Canada have already steepened by 96 and 80 basis points respectively (from the lows of the year to quarter end) – but we feel at least another 50 bps is easily within reach.

**Figure 4: 12 mon sma of YoY US Non-Farm Payroll Growth By Sector**

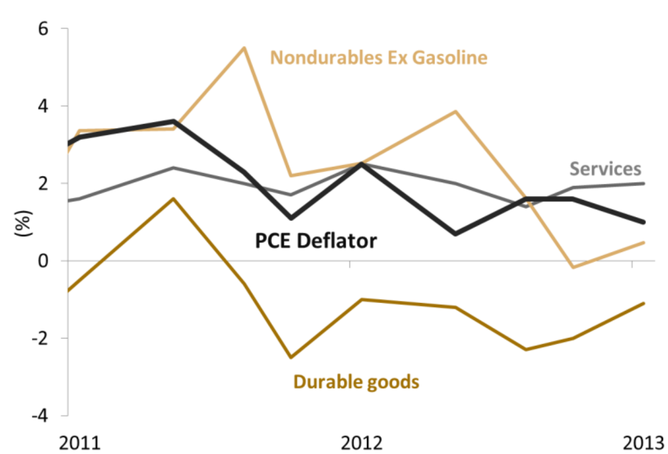



*Source: Bureau of Labour Statistics & Lorica Investment Counsel; as at June 2013*.

In the near term we expect data to be good enough to support the Fed's plans and reinforce investor expectations for a removal of stimulus. Employment growth (see Figure 4) has benefitted mostly from a rebound in consumption, primarily driven by the wealth effect which has been fuelled by a rise in asset and house prices. Although asset prices have taken a hit more recently, equity prices are still up 13.8% for the year and 21.3% over the last two years. And as for house prices, there is still enough momentum behind the housing market, to support higher prices before the rise in mortgage rates begin to have an impact. The surge in building permits and housing starts will also continue to deliver a lagged benefit to employment growth in housing related sectors, an area that had been a drag on employment.

Although the recent decline of inflation could be argued as a reason for concern for the Fed's planned QE exit, Bernanke was unequivocal in his dismissal of softer inflation as transitory. The PCE Deflator currently stands at 1.06% (see Figure 5) which is well below the Fed's target. However, upon close examination of the components, recent dollar appreciation and energy price volatility appear to have had disproportionate impacts, while services and durables have been relatively stable. Uncharacter-istically, we share the Fed's lack of concern over inflation or deflation.

**Figure 5: PCE Deflator With Key Components**

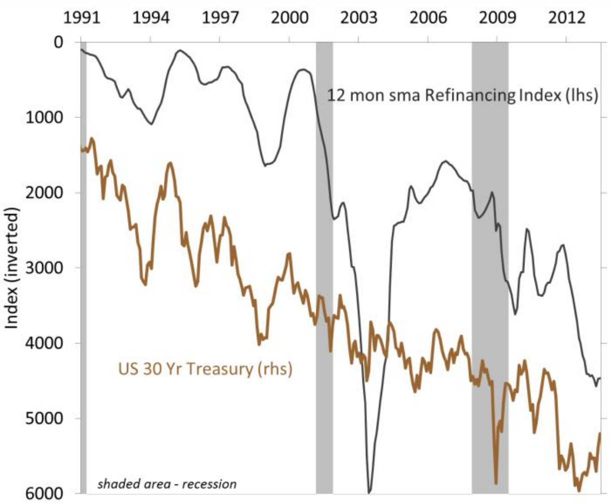



*Source: Bureau of Economic Analysis & Lorica Investment Counsel; as at June 2013*.

LORICA | INVESTMENT COUNSEL INC.

Further out, we are sceptical that a total removal of stimulus is in the cards and expect short-term interest rates to remain below historical norms for some time. Medium term economic growth has consistently disappointed and the Fed (and the Bank of Canada) has shown a tendency to overestimate the recovery. US employment gains have been controversial with the unemployment rate having declined by 0.6% to 7.6% in May (although lower at 7.5% in April) from 8.2% a year ago, with the caveat that the participation rate has dropped 0.4% over the same period. The Fed's median forecast is for unemployment to drop to 7.0% 12 months from now, a feat that will be complicated by any rise in the participation rate. Overall, continued employment gains face challenges including the continuity of support from consumption and the housing sector, and a decline in demand for manufactured exports. Sequestration may also continue to have an adverse impact.

**Figure 6: US Mortgage Refinancing (Inverted) vs Long Bond Yield**




*Source: Mortgage Bankers Association & Lorica Investment Counsel; as at June 2013*.

We have never been entirely sold on the full extent of the economic impact of QE, but have recognised the benefits that have accrued through the wealth effect and lower financing costs more generally. However, as QE3 has induced longer term yields and yield spreads to fall, mortgage rates have hit historical lows and the scope for further refinancing has diminished. (See Figure 6.) Perhaps more importantly to the Fed, lower yields have also created market imbalances related to inflated prices in risky asset classes. While the Fed has been careful to suggest that its policy course will continue to be data dependent, we think the Fed's recent actions indicate a larger desire to withdraw from QE, albeit in hindsight with more elegance than has been the recent experience.

As we had stated in previous commentaries we expected the bond market to be volatile in 2013 with little room for capital gains and had not conceded that yields would yet be on a trend upwards. We still do not believe we are in a secular rise in yields, but rather a rise related to the exit, albeit orchestrated somewhat carelessly, from the Fed's open-ended QE. As such, investors are more likely to demand compensation for taking duration risk through a steeper yield curve, at least until the Fed hastens a retreat or data makes it obvious a retreat is in the offing. The latter parts of the recent sell-off may have been slightly over-done, but we have witnessed significant selling by investors; not surprising given the significant flow into bonds over the last few years. We have shortened the duration of the portfolio signficantly to mitigate the impact of further steepening of the yield curve.

We firmly believe that, over the medium-term, we will remain in a low yield environment, consistent with a world of low growth and low inflation. There are many structural forces at work which will require political and fiscal adjustment before we enter into an era of higher growth and ultimately higher bond yields across the entire yield curve.

**Gary Morris**, CFA
President

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