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What We Think……

The Universe Index

I began my career in the investment business working in the Fixed Income Research at the venerable house of McLeod Young Weir which was, arguably, the premier bond shop in Canada at the time. One of my main responsibilities was running the McLeod Young Weir Universe Bond Index – the forerunner of the DEX Universe Index. Originally, the MYW Index was actually a long bond index composed of a small set of benchmark bonds recorded weekly by the MYW bond traders in a notebook. In the 1980's, with the help of computers, the index was expanded, aggregated by market value, and produced on a daily basis. I was charged with moving the index from a PC to a mainframe environment… imagine that! Today, the DEX is run by the TSX in what is surely a sophisticated operation that tracks a huge list of Canadian public debt issues using multiple pricing sources (the original index was only priced by MYW). You might be asking "what does all this have to do with Lorica's outlook for 2014?" Well the MYW/DEX indices are the oldest reliable record of bond performance in Canada and according to that record there has only been one episode of back-to-back calendar year bond market losses over the last 65 years. That was way back in 1966 and 1967 when 91-day T-Bill yields went from 3.92% to 5.03% back down to 4.59% and the Long Bond index yield went from 6.00% to 6.72% to 7.47%.

Figure 1: MYW/DEX* Index Returns

Year	MYW/DEX Returns (%)	Change in 91day T-Bill (%)	Change in 10Yr Canadas (%)
1951	-7.89	0.27	0.48
1956	-8.87	1.11	0.73
1959	-5.07	1.63	0.86
1966	-1.05	0.42	0.30
1969	-2.86	1.57	1.04
1974	-4.53	0.77	0.15
1979	-2.83	3.20	1.56
1994	-4.31	3.33	2.48
1999	-1.14	0.23	1.36
2013	-1.19	-0.09	0.96

**McLeodYoung Weir Long Bond Index 1949 to 1979*
MYW/DEX Universe Index 1980 to Present

Source: PC Bond, Bank of Canada & Lorica Investment Counsel; as at December 2013.

According to the MYW Bond Index (as it was then called) the combined two-year return was -1.52%. Last year's Universe Index returned a paltry -1.19% which was the first negative return since 1999 and only the second time in the last 35 years. Between 1949 and 1979, negative bond market returns were much more commonplace, according to the Long Bond Index, occurring about every five years interspersed with years of positive (sometimes large) returns. The period was marked by significant bond and equity market volatility and short term interest rates that were trending higher. Notably, in all years when market returns were less than -1%, short term rates rose significantly, except for last year when they were changed. (See Figure 1.) This is an extremely important point when analysing the prospects for bond returns in 2014. In 2013, bond market returns were dictated by the steepening of the yield curve – in the US the curve went from 270 to 385 basis points and in Canada from 137 to 223 bps (measuring long bond yields against overnight rates). We have previously made the case that developed country yield curves would normalize (following the lead of the Treasury curve) and subsequently remain in a holding pattern, albeit with some level of volatility, until short term rates are ready to begin their ascent. We are well past the mid-point of this yield curve normalising move, and expect steepening to continue in the first half of 2014. (See Figure 2.) As for short-term rates, we expect them to remain stable this year, and likely next.

The Math

A simple rule of thumb in the bond market is that for every 1% change in yields (assuming a parallel shift of the yield curve, which never happens in reality, and ignoring convexity) the change in market value of the portfolio will be approximately -1% times the average duration of the portfolio. For example: for a 1% rise in yields the change in market value of the portfolio with a modified duration of 6 years would be -6%; conversely for a 1% fall in yields the change would be 6%. If the current yield to maturity of the DEX Universe Index is 2.7%, it would take a parallel rise of about 40 basis points along the Government of Canada Yield

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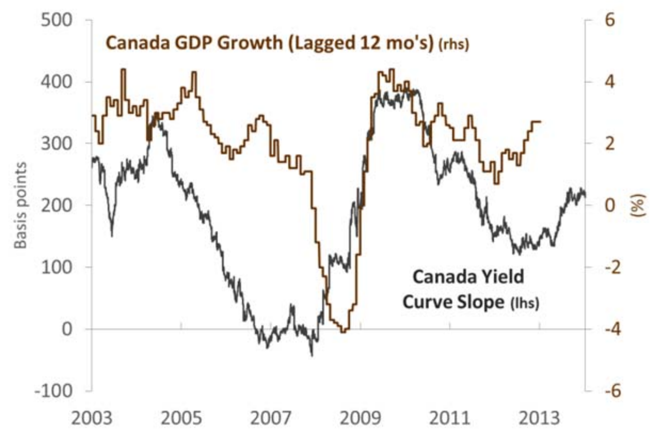
Figure 2: Canada Yield Curve vs GDP Growth (lagged)



Source: Bloomberg, Statistics Canada & Lorica Investment Counsel; as at December 2013.

Curve (assuming no credit spread movement) to wipe out all the interest income of the index over a 12-month period. But, assuming further steepening of the yield curve with stable short rates, we would estimate that roughly another 65-70 bps of steepening of the yield curve (2's – 30's) would be required to produce negative returns – more than is in the cards at this point.

The Overnight Rate

At the December FOMC meeting, Fed Chairman Bernanke announced that the Fed would begin the much anticipated tapering of its asset purchase program by reducing its monthly purchase of treasuries to $40 Bln (from $45) and agency mortgage backed securities to $35 Bln (from $40) starting in January. Leading up to the announcement, the bond market experienced close to six months of substantial volatility as investors struggled to interpret Fed communication. In his zeal to be transparent, Chairman Bernanke mishandled the messaging of the Fed's intentions for QE3, forcing him to backpedal on several occasions. We maintain that the Fed faces the prospect of deteriorating liquidity in treasury markets, not to mention other capital market dislocation, the longer QE3 remains in effect, making it all the more necessary to windup the program. QE3 was instituted in response to double dip and deflationary concerns and was never meant to be a permanent fixture of policy. The fact that it was open-ended, unlike the preceding QE programs, was more for persuasive reasons rather than for intentions of permanency. In any event, notwithstanding the Feds vigorous protestations of data dependency, we believe tapering will continue with the eventual conclusion of QE3 this year. While monetary policy will still be loose, economic stimulus will be reduced, primarily through an adjustment to the rate structure.

As for overnight rates, we think Fed Funds will not move in 2014 and bond investors will price the front end of the yield curve accordingly. As part of the Fed's strategy to end QE3, they have emphasized forward guidance; as forward guidance relates to Fed Funds, the Fed has pushed out the timeframe for increases by fidgeting with unemployment targets. We see some merit to the shift in the Fed's interpretation of the unemployment rate as it is clear their prior targets did not adequately reflect the changes in the participation rate – too many discouraged workers and too many long term unemployed set to come off benefits. However, there also remains a question of how significant a factor the skills mismatch of today's labour force is, and what's to be done about it. In hindsight, one has to question the Fed's wisdom of introducing the unemployment targets just over a year ago, in the first place. Although there is transparency around using visible published data series, changing targets not long after their adoption, diminishes the communication value that this information might otherwise have.

As for the Bank of Canada, we don't expect any movement in overnight rates either. Governor Poloz has dispensed with former Governor Carney's more eye-catching but tiring hawkish stance and supplanted it with a more appropriate dovish tone. The front-end of the Canadian yield curve has fallen and according to OIS Futures, investors are now only pricing in an 8% probability of a hike in the Call Loan rate over the next 12 months. Not surprisingly the Canadian dollar has declined by 5.2% since Poloz assumed the Governorship. (It is interesting that Finance Minister

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Flaherty seems to be bent on sending a hawkish monetary policy message – not his responsibility anyways – as he continues his fight against consumer over-indebtedness. Consumer debt levels have begun to come down and we think that this is perhaps an old war that doesn't warrant another battle.)

The US Economy

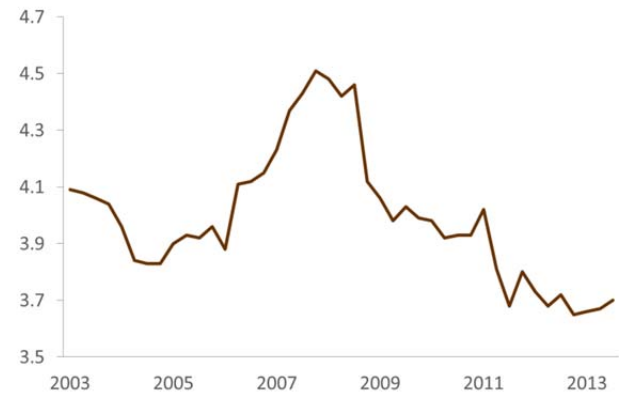
The economic recovery since The Great Recession has been the weakest post-recession recovery on record in the post world war period with growth averaging 2¼% per year versus an historical average of just over 4% in the four years following a recession. As mentioned earlier, we expect the Fed to substantially maintain its support for the economy with low short-term rates and asset purchases that are declining alongside declining government issuance. On the fiscal front, the Ryan-Murray budget does water down some of the restraint caused by Sequestration, despite ignoring most of the difficult key budgetary issues. In addition, on a positive note, the budget agreement removes some level of policy uncertainty; however the exhaustion of the debt ceiling limits in February will likely ensure it gets ramped up again.

Q3 was a surprisingly strong quarter, arguably due to the significant inventory rebuild that took place. The impact of higher bond yields will likely be felt in Q4 and Q1 of this year, as mortgage refinancing has, not surprisingly, suffered a huge decline. On the other hand, the relentless rise of the equity markets and the more subdued rise of house prices will no doubt have contributed to a wealth effect that may be evident in terms of consumer spending. However, early indications of end of year shopping activity do not indicate robust retail sales results – volumes are up, but at the expense of heavy discounting. There are still legions of unemployed workers in the US, many whom have dropped out of the labour force. Unfortunately, many of those recently employed have only found jobs in low paying retail and hospitability sectors. There have been better paying employment gains in other sectors, notably energy, technology, and health care related, but the numbers there are not sufficient to generate significant overall income growth.

The Canadian Economy

Canada has been the poster child amongst its G7 piers for most of the post-recession period. (Germany deserves mention here, but it is tainted by association, as a member of the Euro.) Fortunately, we had decent banking, consumer, and housing fundamentals going into the recession. Unfortunately, in terms of housing and consumer fundamentals, we have used the last five years to play catch up. Consumer debt to income reached record levels in Q3 2013 while the average home equity reached record low levels in Q4 2011. Record low financing costs and reasonable income growth (averaging 3.7% over the last five years) has caused house prices to rise 10.2% since mid 2009 (Statscan), while house affordability has fallen. (See Figure 3.) Canada's housing market has been notoriously difficult to forecast, so we don't intend on making any sweeping statements here, except that it will likely be a more challenging environment than last year.

Figure 3: Housing Affordability – Mortgage Debt Interest per Disposable Income



Source: Statistics Canada & Lorica Investment Counsel; as at December 2013.

Further complicating the Canadian outlook is Canada's commodity complex which, outside of energy, has had it tough lately with prices excluding energy falling 13.4% in 2013; fortunately energy prices were up last year and extreme cold weather should ensure more price gains going forward. As for manufacturing, it is still too early to see any kind of adjustment to a

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cheaper looney and plant closures will not likely reverse anyway – we expect manufacturing will likely continue to be a drag on the economy in 2014. Note December's trade deficit makes it 23 straight months below zero for an average deficit of 621 Mln since January 2009.

The Inflation Outlook

In economies facing deleveraging, it is not surprising that growth is subpar and deflationary concerns are present. In fact we would suggest that deflation is the biggest risk to our outlook. Despite excessive amounts of stimulus, the Fed has been unable to eliminate the downward pressure on inflation. The US Core PCE deflator is again flirting with 1% yoy, having fallen from just over 2% in March 2012. Data suggests that there is little pressure on the price of goods and, if anything, producers are searching for ways to cut costs because of a lack of pricing power. The strength of the US dollar is also deflationary via lowering import prices, particularly relevant given the large US trade deficit. We believe that energy discovery and innovation will keep a lid on energy costs and any risk of pass-thru to the price of goods. We are generally of the opinion that energy prices are not inherently a catalyst for a change of inflation expectations, as a corresponding change in wages is far from guaranteed. There are some commentators predicting wage pressures, although we don't expect this to be the case given our employment outlook.

The Canadian inflation picture is a little murkier as it has been difficult, in the past, to forecast the level of price adjustment to changes in the value of the Canadian dollar. This was particularly true when the Canadian dollar appreciated from 2002, but may not be the case when the CAD is depreciating and importers have an incentive to adjust prices upwards.

The Credit Markets

Credit has had a good two-year run during which time investors have been rewarded for going overweight and down the credit quality spectrum, while the Fed has pretty much protected them from adverse market risk. According to the DEX Universe Index, over the past two year's Universe corporates outperformed Universe governments, and BBB's outperformed AAA/AA's. (See Figure 4.) Credit will be inherently more risky in 2014 as the insurance from the Fed cannot be counted on to the same degree nor will the flow into the sector be as likely. We think that corporate and provincial credit will offer reliable yield pickup in 2014, but will not be as satisfying in terms of yield spread performance. The Fed has tried to provide assurance that it will be there to backstop the market if necessary [read: support equities and credit] but there is always the risk that they mistime their actions and credit and/or equity markets suffer in the process. There is also the minor question of how direct the impact of asset purchases has ultimately been on credit demand and spreads, and what impact tapering will have as it unfolds.

Figure 4: DEX 2-Year Return

Sector	Short Index (%)	Mid Index (%)	Long Index (%)
Canadas	1.02	-0.08	-2.60
Provincials	1.72	1.74	-1.27
AAA/AA	2.80	3.53	2.81
BBB	3.60	4.91	4.77

Source: PC Bond & Lorica Investment Counsel; as at December 2013.

The Bottom Line

In 2013 many investors fled the bond market, anticipating that we would be in the first of many years of negative total returns. 2013 did prove to be challenging, as credit exposure was no match for rising yields combined with long duration. We took the aggressive step of reducing the portfolios duration midway through last year and plan to keep it there until the yield curve reverts back to a more normal, unadulterated shape - a scenario likely to unfold in the first half of 2014. Beyond, we think central banks will remain on the sidelines content to see the economy slowly (and we emphasize slowly) improve. At that point, there will be a better opportunity for picking up yield from a steeper yield curve and longer, less vulnerable credit.