



LORICA | INVESTMENT
COUNSEL INC.

Focused Fixed Income

Market Highlights

Weather was the dominant theme in Q1, clearly from an existential perspective, but also from a notional perspective – when understanding the impact on the economy and markets. Data was weak, and in many cases weaker than expected. Investors appear to have chosen to interpret the weak data as originating from a temporary shift in demand, which will be reversed in the spring (whenever it should choose to appear).

In terms of the bond market, 10-year Treasury and Canada yields fell by as much as 44 and 47 basis points respectively, but both markets ended the quarter only 31 bps lower than where they started – not a conclusive response to the weak data. Yield volatility for the quarter was relatively low, particularly in the U.S. where it was well below its average of the last two years. Volatility in Canada did not show as significant a decline during the quarter, largely because Canadian yields moved mostly in sync with US yields, whereas more typically US yields tend to have higher beta.

The Fed's tapering program continued, unabated, through Q1 signaling its desire to wind down QE. At the same time, the Fed's challenges with forward guidance and its messaging, also continued unabated, as new Fed Chair Janet Yellen was forced to mute investor response to her March 19 press conference and to suggestive comments from other FOMC members. Short term bond yields in both Canada and the US remained virtually unchanged over the quarter, supporting expectations that the Fed and the Bank of Canada will remain on hold for the foreseeable future.

We would be remiss if we did not mention events in the Ukraine (as did the Bank of Canada, somewhat surprisingly, in its latest policy press release), and the temporary flight to safety that followed. It appears that there is not much appetite for an escalated conflict on all sides, so we expect the situation to begrudgingly diffuse. The initial flight to the bond market was limited, and has mostly been reversed.

Finally, credit spreads were firm during the quarter, providing support for a broad base of new issues. In all there were \$21.6 billion of new issues, just under last year's record total of \$22.3 billion. Aside from banks with a combined \$11.8 billion, Real Estate and Telecom/Cable had the most issuance at \$1.9 and \$1.6 respectively. Most issues came with decent concessions, which lured investors.

Portfolio Activity

After a significant rally we took the opportunity to reduce our exposure to pensions and reallocate it to pipeline/utility

holdco debt which provided an attractive risk-adjusted yield pick-up. The portfolio was optimally structured on a yield curve and sector basis relative to our interest rate and sector forecasts, and thus yield curve positioning was limited.

What Worked In The Quarter

The portfolio has an overweight corporate exposure (on both a market weighted and duration basis) relative to the index with a concentration in higher yielding short-term financials and telecom/cable issues which relatively outperformed. Corporate spreads tightened on average 10 basis points during the quarter. Additionally, the portfolio was underweight provincial issues which modestly underperformed on the back of the Quebec election call and a predilection to allocate credit risk to higher yielding sectors.

What Didn't Work In The Quarter

The portfolio is structured with a short duration via a concentration in the one year area of the yield curve in lieu of maturities 10 years and longer. For the quarter 5, 10 and 30 year yields fell by 25, 31, and 27 basis points respectively, whereas 1 year yields fell by 3 bps. The portfolio underperformed on this bull flattening move of the yield curve.

Outlook & Strategy

We expect US nominal yields to rise as real yields continue to normalize, with growth improving and the Fed eliminating bond purchases, despite relatively few inflation pressures. Canadian longer-term yields will continue to track those in the US. We believe the Fed will continue to try and manage longer-term yields through forward guidance. However, while the Fed may back away from its unemployment targets, it will likely continue to emphasize its downward biases so as to prevent investors from being too pre-emptive. Consequently, bond investors will either appear early or be too late – we have chosen the former. The portfolio's duration is still short at about 4.2 years – 2.5 years less than the benchmark, with very few bonds with a maturity of ten years or more.

Credit markets will likely remain firm so long as the rise in bond yields is limited to a normalization of the yield curve. Should investors become too aggressive and the Fed unable to contain the rise in short term yields, there is the possibility of weakening of the credit markets. The overweight in credit will be kept to enhance the overall yield, with overall higher credit quality to protect against potential spread widening in the event of weaker fundamentals.