LORICA | INVESTMENT COUNSEL INC.

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Focused Fixed Income

Market Highlights

North American bond markets are caught in an intense struggle between the forces of US recovery on one hand and European and Japanese stagnation on the other, with the penultimate arbiter – the Federal Reserve – treading precariously in the middle. The struggle was never more evident than during the last quarter when US and Canadian yields were prevented from responding to the relatively strong US economic data by successive declines in European bond yields, whilst the Fed stirred things up with ambiguous communication. Never-the-less bond investors have begun to plan for a day when the *risk-on* trade is no longer in vogue.

Not surprisingly yield and yield spread volatility, rose significantly during Q3, aggravated by slimmed down dealer inventories which proved a poor match for marginal market flows. US Treasuries were volatile, e.g. 10-years traded in a 31 basis point range but ended the quarter exactly where they started. Canada's were similarly volatile, with 10-years trading in a 33 bps range, but ending the quarter 9 bps below where they started. Finally, corporate bonds were also volatile – Canadian corporate mid-term AA and A yield spreads traded in 11 and 10 bps trading ranges respectively – finishing at the upper end of the ranges at quarter-end.

Capital markets also had to contend with an onslaught of geopolitical risks (Israel-Gaza, ISIS, Russia-Ukraine, Scotland, etc.) that seem to be a constant feature of today's globalized markets. Although the world pre-Credit Crisis was not devoid of geopolitical risk, the linkages today, between global markets and global economies are that much stronger, while the global economy is that much weaker.

Portfolio Activity

We opportunistically increased exposure to higher-yielding, shorter-dated issues in life insurance, autos and banks, which have solid credit metrics and should outperform in a rising rate environment.

What Worked In The Quarter

Relative to the index, the portfolio was significantly overweight corporates and provincials on a market value weighted basis providing yield enhancement, but neutral and underweight respectively on a duration basis, thereby reducing sensitivity to yield spreads. Corporate and provincial spreads widened on average by 6 and 1 basis points respectively during the quarter.

What Didn't Work In The Quarter

The portfolio was structured with a short duration via a concentration in the short-end of the yield curve in lieu of maturities 10 years and longer. For the quarter 5, 10 and 30 year yields fell by 0, 9 and 11 basis points respectively.

Outlook & Strategy

We are confident that the US recovery will continue, albeit at a moderate pace – gone is the exuberant housing led, consumer driven growth of the previous decade, replaced with more balanced, sustainable but moderate growth. Europe and Japan will continue to struggle with poor demographics and too much sensitivity to exports; while the BRICS should do better. Fortunately for Canada, its exports are still dependent upon the growing US economy, which should bode well.

The bond market will adjust upwards, as first US and then Canadian monetary policy adjusts to the reality of a US recovery that is on firm footing. The front end of both yield curves will be higher as investors price in higher short term rates that will be in place next year. The long-end in both markets have begun to detach themselves from central bank QE and forward guidance, but this process will be ongoing. Lower bond yields in Europe and Japan will continue to act as a magnet to North American yields which has resulted in some flattening of the US yield curve, but less for the already-flat Canadian yield curve. Given the relatively low carry in bond markets, returns will likely be low. We believe less market risk is warranted and will maintain a relatively short duration position to mitigate a rise in yields.

Owning credit has been a profitable strategy as long as the Fed and a sidelined BoC have been supportive. The question facing investors is how much valuations reflect the economy or the central bank supported level of risk. Given the uncertainty embedded in valuation and the reality of poorer market liquidity, we think a more conservative orientation to credit is justified.

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