LORICA | INVESTMENT COUNSEL INC.

September 30, 2014

Short Term Bond

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 September, aggravated by slimmed down dealer inventories which proved a poor match for marginal market flows. US Treasuries were volatile, e.g. 5-years traded in a 21 basis point range and ended the month 13 bps higher. Canada's were similarly volatile, with 5-years also trading in a 21 bps range, ending the month 11 bps above where they started. Corporate bonds, however, were less volatile – Canadian corporate short-term AA and A yield spreads traded in 3 and 4 bps trading ranges respectively – finishing at the upper end of the ranges at month-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

No significant activity was performed.

What Worked In The Month

The portfolio was overweight corporates and provincials on a market value weighted basis providing yield enhancement.

What Didn't Work In The Month

The portfolio was overweight corporates and provincials on a duration weighted basis leaving it exposed to yield spread widening during the month. However, spread widening was limited to 2 and 1 bps on average for the corporate and provincial sectors respectively, according to the FTSE TMX Canadian Short Term Index.

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. 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 so for the already-flat Canadian yield curve. Given the relatively low carry in bond markets, returns will likely be low. With the more limited duration risk in short bonds, we are comfortable with a neutral duration at this time.

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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