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What We Think……

The Second Half…

Now that we have gotten through the first half of the year, it is time to let go of the weather distortions and the geopolitical crises that have dominated investor psyche and look forward to the economic reality that will ultimately dominate markets. Of course, the other dominant factor – the Fed – is still alive and kicking in, some might argue, even better playing form, with a newly ensconced captain and updated roster. Although Janet Yellen has been around the Eccles Building (where the Fed meets) for some time, she does not carry the baggage of being the lead architect of the QE program nor the author of controversial procedural changes. In many ways, Yellen is freer to direct the Fed than Bernanke would be at this point, although it still remains to be seen when she will begin to chart a substantially new course.

We think the economic data is pointing to a stronger US economy and, perhaps more importantly, tighter labour markets. Job growth has averaged 272,000 for the last three months, and although not stellar in the context of past recoveries, the trend is clear and stable. The unemployment rate, now at 6.1%, has been declining consistently, edging closer to conventional levels of full employment – somewhere around 5.5%. Janet Yellen has continued to emphasize the decline in the participation rate as evidence that there is more slack than the headline unemployment numbers reveal. However, there is reasonable evidence that a meaningful portion of the participation rate decline is related to the ageing workforce and retirement, as well as other structural impediments, such as skills mismatch and less workforce mobility. Our take is that as long as the unemployment rate continues to decline, even modestly, wage pressures, in at least specific pockets, will not be that far off. Currently the YoY change in average hourly earnings is not yet a concern at 2.0% YoY as at June compared to 2.2% this time last year and 2.0% two years ago.

Admittedly, current US economic growth appears lacklustre – likely to average no more than 2% for 2014, but one has to look beyond the first half of the year. The most recent data suggests economic growth could average between 3-4% in the second half, led by improvement in manufacturing and housing. The recent manufacturing reports including the national and regional ISM's all point to significant contribution from manufacturing with steady improvement since December. Notably, transportation is leading the way with the most significant contributions coming from autos followed by aerospace. In terms of housing, starts stayed above million in May, continuing the mark set in April, after the poor first quarter when starts averaged just 925,000. The growing number of starts combined with the continued pace of permits (just under one million) should greatly benefit domestic growth in the second half of 2014.

We believe that the inflation picture is changing. That's not to suggest we think inflation is poised for uncontrollable acceleration, but rather, we expect to see a visible increase from the sub-Fed target levels experienced during the last twelve months. The US CPI came in at 2.1% in May, the highest reading since October 2012, and the Core CPI came in at 2.0%, which is at the higher end of the range that has held since June 2012. Given the improved outlook and pockets of wage pressures, these levels should increase further. We note that Fed, Yellen in particular, seems unfazed by the inflation numbers, with the Chairwoman responding that there is much "*noise in the current data*" when asked to comment about rising CPI, during the recent post-FOMC meeting press conference. It should be noted however, that the Fed pays more attention to the Core PCE Deflator which has only just begun to turn up, but based on historical behaviour can be counted on to follow the CPI moves.

To this point in 2014, the bond market has pretty much ignored the growth story and only begrudgingly paid attention to inflation. But then, that should not be a surprise as the Fed largely "owns" the yield curve and Yellen and team have not been shy about their intentions to keep it low, despite tapering its QE program. The Fed's other "program" of lowering *threshold guidance* has effectively kept a ceiling on longer term yields, and there are no signs of an

Gary Morris, CFA
President
T. 647.776.8111 E. info@loricaic.com www.loricaic.com

US Fund Flows

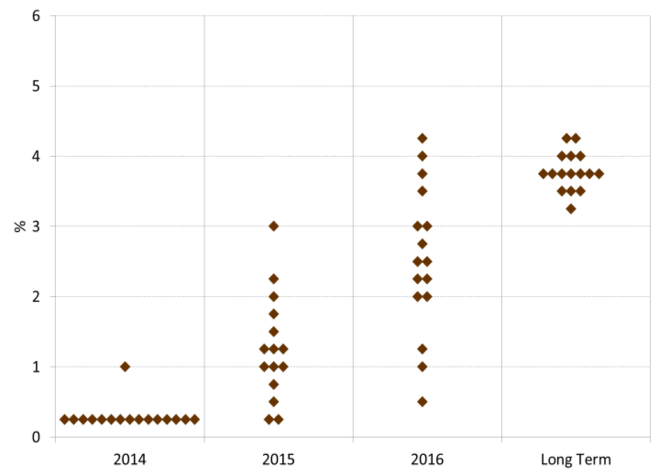
The financial crisis was marked by significant declines in both economic growth and equity markets, with the latter bottoming in March of 2009 (according to the S&P 500). What may come as a surprise however, is that while equity markets have grown fairly consistently from the bottom, US fund flows into equities continued to be volatile, with regular periods of outflow, up until the end of 2012 (according to data from the Investment Company Institute, all amounts USD). In fact the average monthly flow was an outflow of $6 billion from April 2009 to December 2012. It has only been since the implementation of QE3 that equity fund flows have been positive, averaging $13.6 billion per month from January 2013 to April 2014.

In contrast to equity mutual funds, bond mutual fund flows have been essentially positive following the financial crisis, that is up until June 2013 when then-Fed Chairman Ben Bernanke signalled to the market that QE3 was likely to end. Investors interpreted Bernanke's comments as meaning imminently and pulled money out of bond funds in dramatic fashion from June to December at a monthly pace of $24.3 billion; notably, equity funds flows averaged $11.5 billion during this period. Although, subsequent Fed communication has tried to calm bond investor fears, bond fund inflows have only averaged $7.2 billion per month in 2014, compared to the average monthly inflow of $21.1 million from April 2009 to May 2013.

It remains to be seen what effect a further change in monetary policy will have on US fund flows. There is a risk that some of the flow that has moved into equity funds in the past 18 months may reverse course, but we feel this will not represent substantial amounts, given our expectation for continued improvement to the US economy. At the same time, we don't anticipate investors moving back into bond funds, so long as the most likely next move of significance is for a rise of bond yields.

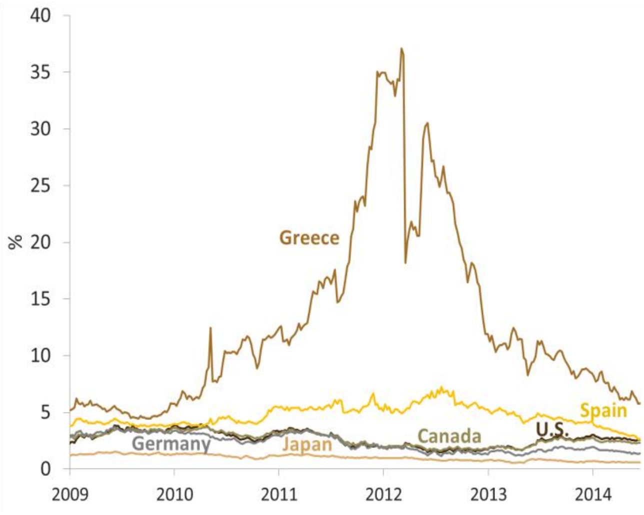
imminent change in course. We can only surmise that, for the time being, the Fed, on the whole, would be comfortable with core inflation rising to 2.5%, while continuing to focus on the low participation and high underemployment rates, thereby keeping monetary policy easy until they are absolutely ready for a tightening. (Although we think Yellen prefers a dovish stance, recent dot charts from the Fed, suggest this position is not shared by all. (See Figure 1.)

Figure 1: Expected Fed Funds Rate of FOMC Members



Source: Federal Reserve & Lorica Investment Counsel Inc.; June 2014.

Figure 2: Sovereign 10-Year Yields



Source: Bloomberg & Lorica Investment Counsel Inc; June 2014.

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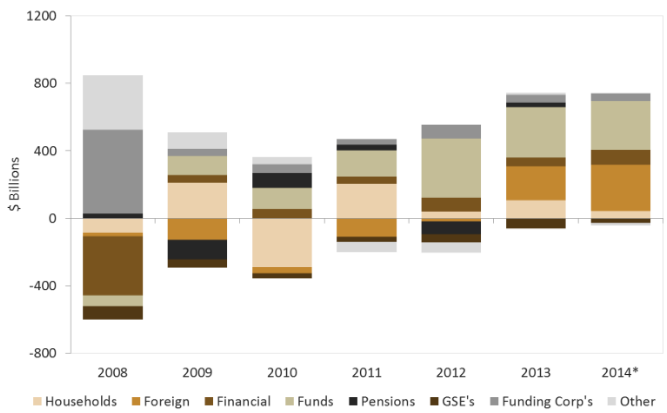
While the US economy is looking healthier, the same cannot be said for most developed economies around the world. Europe is clearly struggling, which has forced the ECB on a path of increasing accommodation, and Japan has shown only an erratic response to the over-zealous policies of the BoJ. It should therefore, be no surprise that developed country sovereign yields have fallen precipitously, such that even 10-year Spanish yields have now fallen below 10-year US yields. (See Figure 2.) Correspondingly, attractive US yields have encouraged foreign flows into the US bond market, which in turn has had a dampening effect on the rise of US yields. (See Figure 3 & 4.)

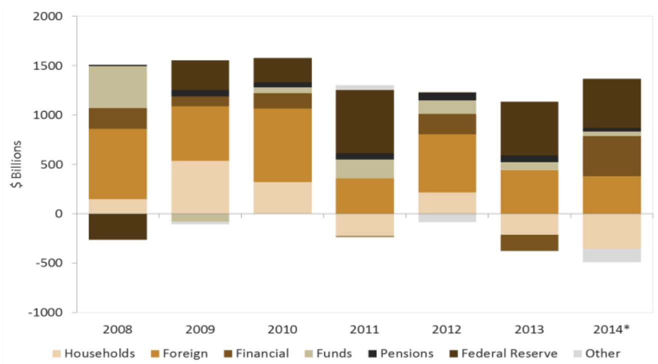
Figure 3: US Treasury Market Flows



**2014 is Q1 at Annualized Rate*

Source: Federal Resserve Board & Lorica Investment Counsel Inc.; March 2014.

Figure 4: US Corporate Bond Market Flows



**2014 is Q1 at Seasonally Adjusted Annual Rate*

Source: Federal Resserve Board & Lorica Investment Counsel Inc.; March 2014.

International investment has not been the only flow of funds supporting the US bond market. Financial institutions (which includes banks, brokers, and asset managers), who had been net sellers of bonds in 2013, have been one of the biggest sources of investment so far this year. As for the the Fed, though it is steadily diminishing its asset purchase program, it is still reinvesting the coupons and maturities from its vast holdings. Households appear to be the most significant investor base disinterested in bonds, representing a major source of Treasury sales – on pace to be about $350 billion in 2014.

Into Extra-Time…

We are going through a period where we believe underlying economic factors warrant a rise in yields but financial flows into the bond market and monetary policy have not yet been supportive of this view. The dynamics for bond market flows are less certain in the short term – there are a variety of sources, such as sovereign yield spreads, asset prices, and investor sentiment, which are less influenced by domestic US fundamentals. However, in the medium term, assuming economic conditions remain positive, we expect monetary policy to reluctantly come into line, which will eventually impact flows to the bond market. It is this dynamic, stemming from even a subtle change in monetary policy, which has the potential to increase bond yields quickly.

We expect the longer end of the Canadian bond market to follow the direction of the longer end of the US bond market. However, the Canadian yield curve will likely remain flatter than the US yield curve as investors are forced to factor in the Bank of Canada's current dovish messaging. The fairly resilient Canadian housing market, improved manufacturing on the back of last years weaker Loonie, and the surprising rise in Canadian inflation will make it difficult for the Bank to continue to suggest its next move will be lower. The market has already priced some policy change into the front end of the Canadian yield curve and the Canadian dollar, and as the US economy continues to improve with some benefit to the Canadian economy, we would expect more to follow.

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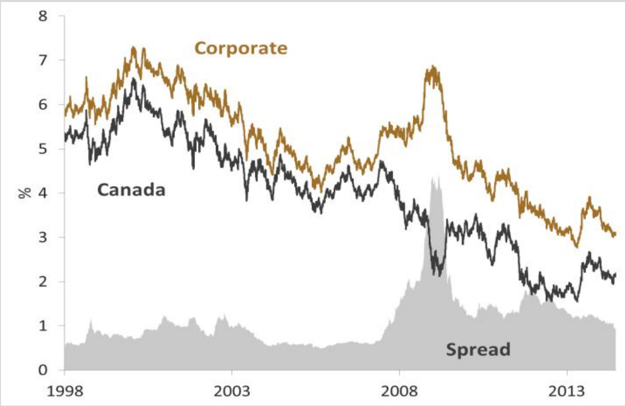
Canadian Corporate Bonds

Falling corporate yields have proven to be attractive to Canadian corporate treasurers looking to raise money, while at the same times investors have not been deterred by continuously declining yield spreads. (See Figure 5.) Although corporate bond issuance had fallen to $59 and $57 billion in 2008 and 2009 respectively, from $81 billion in 2007, it has steadily risen since that time, nearly doubling to $109 billion in 2013 (all amounts in CAD). Low overall bond yields have certainly induced more investment into corporate bonds, where the yield pickup as a percentage of absolute yields has been high by historical standards. When compared to yield spread levels prior to the credit blow-up of 2008, there is still room to go lower, but our recollection of that period was one of relative indifference to yield spread risk. There is no question that recent monetary policy has created some level of similarly risky behaviour, but we believe that we are near the end of bottomless Fed support and, hence, further yield spread declines will be scarce.

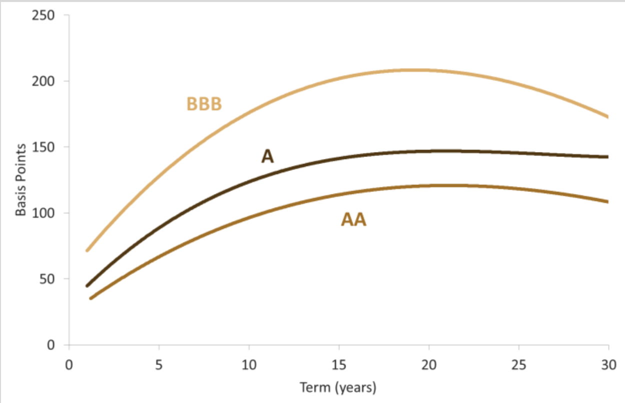
Looking at the Canadian corporate yield spreads according to credit rating, one can see that up to about 15 years term-to-maturity, investors are compensated for taking on greater term risk with upward sloping yield spread curves. (See Figure 6.) However, beyond 15 years, the yield spread curves flatten out indicating more scarcity of supply relative to the embedded demand from pension funds and life insurers looking to match longer term liabilities. (Although long BBB's are overpriced to some degree, much of the inversion of the BBB spread curve relates to the limited sample set of the BBB universe.) The industry spread curves show differences in term premium across industries. (See Figure 7.) Not surprisingly, the largest premiums are in the lower rated sectors of industrials and communications; and the lowest premiums are in infrastructure, where the yield spread curve is relatively flat, reflecting investor comfort with longer term infrastructure debt.

Figure 5: Canada & Corporate Mid-Term Yields



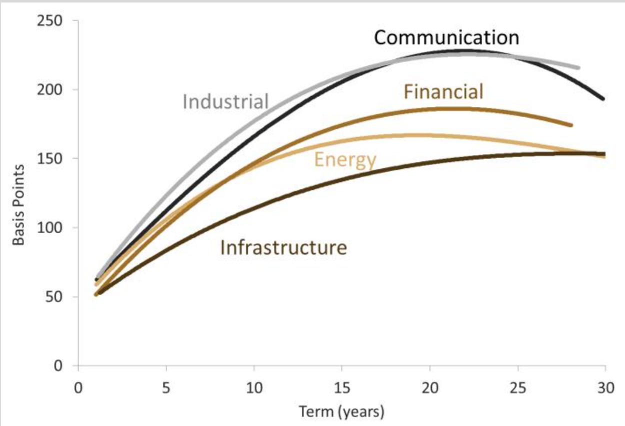
Source: Bank of America Merrill Lynch & Lorica Investment Counsel Inc.; June 2014.

Figure 6: Canadian Ratings Yield Spread Cuves



Source: PC Bond & Lorica Investment Counsel Inc.; June 2014.

Figure 7: Canadian Industry Yield Spread Curves



Source: PC Bond & Lorica Investment Counsel Inc.; June 2014.