June 30, 2015

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

The Canadian yield curve spent the early part of Q2 reversing the flattening from the early part of Q1. In both quarters most of the move took place in the first month with yields trading within a relatively narrow range for the balance of the quarter. The curve steepening was noteworthy as 10-year and long yields rose nearly 40 basis points while 2-year yields were virtually unchanged. Volatility was noticeably higher in June, reflecting reduced liquidity in North American bond markets.

The major market headliners – the *Fed* and *Greece*, gave investors less reason to continue buying bonds In April. Economic data began to show improvement and put the Fed back in play for the fall; and German yields, which had fallen too far in response to ECB QE and Greece contagion fears, reversed course taking Treasuries and Canada's along with them.

Bank of Canada Governor Poloz continued to defy investors with, what have become signature miscues – in April he told Reuters about current monetary policy saying: "It gets us home", seeming to indicate there were no chance of further moves. But the reality is negative first quarter growth with the potential for second quarter to disappoint could prompt the bank to make a move. Notably, both manufacturing and retail sales disappointed in April, but there is hope for a rebound in May and June on the back of better employment gains.

Although corporate yield spreads were not as volatile as government yields, spreads did widen towards the end of the quarter. The outflows from bond portfolios in general, managed to impact the corporate market which had been fairly resilient this year. We have started to notice that new issues are not getting the same enthusiastic reception they received earlier and spreads in the secondary market are under some pressure.

Portfolio Activity

On the back of auto supply pressure ($2.4 billion issued in Q2) and steepening of the credit and underlying government yield curve, the portfolio opportunistically increased exposure to corporates. Overall credit quality was improved while the portfolio's duration and yield curve bias for rising rates and a steepening yield curve was maintained.

What Worked In The Quarter

Relative to the index, the portfolio is more conservatively structured with a shorter duration and an overweight in the belly (5 year) of the yield curve in lieu of long bonds. For the quarter, 2, 5, 10 and 30 year government yields rose by 0, 4, 32 and 32 basis points respectively.

The portfolio was underweight provincial credit on a duration weighted basis as provincial yield spreads widened by an average of 4 basis points during the quarter. The provincials holdings were concentrated in Ontario and Quebec issues which were top performers.

The portfolio's credit quality (which increases with term) was positive, as spread widening from AA to BBB-rated debt increased as one moved out the credit curve. Additionally, the portfolio's corporate sector distribution benefitted from an overweight in shorter-term higher yielding insurance and bank debt (as a source of added value).

What Didn't Work In The Quarter

Relative to the index, the portfolio was modestly overweight corporates on a duration weighted basis as corporate spreads widened by an average of 9 basis points during the quarter. However, the portfolio was significantly overweight corporates on a market value weighted basis (via shorter-term corporates) providing yield enhancement.

Outlook & Strategy

There are reasonable indications that economic growth in the US has rebounded from the adverse winter conditions and should continue to do so through the summer. Nevertheless, the debate surrounding a September move by the Fed is still animated. We expect the Fed to hike in September, noting that it has highlighted its data dependent mode, and the fact that the data no longer justifies *Zero Interest Rate Policies*. We do not expect the Bank of Canada to match any increase from the Fed.

The yield curve steepened in Q2, erasing the flattening that took place in Q1; we expect this process to continue in Q3, erasing some the flattening from Q4 of last year. With Canadian overnight rates unlikely to head higher anytime soon, the risk of re-flattening in Canada is minor, unless the economy or inflation suffers unexpected declines. The portfolio is positioned with a short duration in anticipation of higher long term yields.

Liquidity is a big risk to both sovereign and corporate markets (see Q3's ***What We Think…***) and we expect to see more yield volatility in Q3. However, we feel yield spread volatility will be more limited and are therefore comfortable with our corporate overweight.

A note about Greece: There is no question that Greece will continue to dominate the headlines, but we do not feel it will be a huge capital markets event outside of Greece. We feel the Eurozone is more than capable and prepared to ring-fence any fallout from a Greek default and potential Euro-exit.

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