June 30, 2015

LORICA | INVESTMENT COUNSEL INC.

Short-Term Bond

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. While 2-year yields fell by 4 basis points 5 years rose by4 bps, though were up as high as 37 basis points through the quarter. 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

The portfolio maintained its relative short duration exposure and steepening bias throughout the quarter.. The provincial weighting was opportunistically increased on the back of widening provincial spread to capture extra yield enhancement.

What Worked In The Quarter

Relative to the index, the portfolio is mildly more conservatively structured with a shorter duration and an overweight in 2 and 3 year bonds in lieu of 4 and 5 year paper. For the quarter, 2, 3, 4 and 5 year government yields moved by 0 -2, -3 and +4 basis points respectively.

Provincial holdings were concentrated in Ontario and Quebec issues which were top performers.

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 short-term corporate spreads widened by an average of 8 basis points during the quarter. However, the portfolio was significantly overweight corporates on a market value weighted basis 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.

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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