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What We Think……

The US Economy

The US economy, on an improving trend for most of the last year, has recently shown some cracks, causing Fed watchers to rethink their positions while eliciting concern amongst investors. There appear to be two opposing forces at work: the strength of the domestic economy propelled by households versus the weakness of the energy sector, which has both slowed domestic gains and curbed export demand by strengthening the dollar and wounding the economies of energy producers who import from the US.

The decline in energy prices has undoubtedly had a significant impact on petro-dependent economies such as Brazil, Russia, and Norway. But one should not also underestimate the impact on segments of the US economy. With the advent of *fracking* technology, employment growth in the energy-rich states of Texas, Colorado, Pennsylvania, Oklahoma, and North Dakota has reversed since the bust in energy prices. In the last nine months, Mining and Logging employment in the above-mentioned states fell by 49 thousand compared to a gain of 32 thousand in the preceding 9 months. Beyond actual job gains and losses, the slowdown in the energy sector has also had an impact on wages, given that wages in the energy sector have typically been above average and certainly higher than many of the lower paying jobs that now make up much of new hiring across the US.

The average monthly increase in Nonfarm Payrolls over the last twelve months was a healthy 229,000, but the average over the last three months was disappointing, at 167,000, reflecting the slowdown in the domestic job market. However, it is still likely that the unemployment rate will continue to fall, due to a continuing decline in participation resulting primarily from a demographic shift as boomers retire. Although the underemployment rate is still a couple of percentage points higher than pre-recession, there is no evidence to suggest imminent re-entry from discouraged young workers – the primary source of underutilised labour. As for wages, despite the low unemployment rate, wage pressure has been absent, a situation likely to continue, given that a majority of job growth has come from lower wage sectors such as retail trade and leisure and hospitality.

The domestic economy continues to be the source of greatest optimism in the US economy, as consumers benefit from healthier balance sheets and from gains derived from the gas price dividend over the last 14 months. Notably, car sales have been extremely strong, with domestically produced auto sales surpassing the 14 million mark (14.36) for the month of September, the first time since 2005. The housing market has also been robust, with upward trends for both new and existing home sales. However, the most recent data for pending home sales suggest that there may be some knock-on effect in the pipeline from a slowing labour market, with both August and June showing sizeable decreases.

Trade is perhaps the most troubling part of the US economy as trade partners undergo various forms of economic retrenchment. August's US trade balance widened by 16% from July as exports decreased by 2% while imports increased by 1.2%. Most headlines emerging in the last quarter originated with China, relating to its economic slowdown and stock and currency market problems. On the surface, more material impacts to US growth appeared to be the decline in exports to Canada (more than offset by the decline in imports) and the widening of the Mexican trade balance by 21% YoY versus 15% YoY for China ($4.7 billion). However, when also considering China's trade balances with countries whose goods consist substantially of Chinese-originated content, such as those from other Pacific Rim countries, where the trade balance widened by 45% YoY ($2.4 billion), China's impact is more substantial. With the US dollar index appreciating 12% over the last 12 months and many countries having a preference for a strong US dollar, it will be difficult for the US trade deficit to fall to a more favourable position in the near-term.

US inflation has been fairly benign with reasonable arguments for both a move lower and the status quo. On one hand, one can argue in support of lower

Gary Morris, CFA
President

T. 647.776.8111 E. info@loricaic.com www.loricaic.com

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inflation: weak fundamentals for commodities, low labour force participation, slow growth globally, and a very strong US dollar. On the other, one can retort in support of higher inflation: commodity prices have already fallen substantially, unemployment is back to pre-recession levels, the US economy is only minimally exposed to global growth, and a strong US dollar will only exacerbate the US's already wide trade deficit. We anticipate a gradual increase as commodity price declines are passed through and pockets of wage pressures emerge.

On balance, we see the continuation of moderate US growth as the most probable scenario. Although the US consumer faces some headwinds, most noteworthy being the reverse wealth effect of a minor reversal in the stock market and the effect of weakness outside the US, we don't see a reason for a significant pause to growth.

What's With The Fed

The adage goes "don't fight the Fed" and we have generally subscribed to this principle, although now we are less certain of *who we are or are not fighting and what we are (not) fighting about*. It is hard to believe that it was only January 2012 when the Fed assigned a hard target for inflation and December 2012 when it first assigned a target for unemployment (subsequently dropped in March 2014). In the context of central banks, setting a hard inflation target is common. (Most central banks do not have the corollary of a hard goal for growth or some proxy such as the unemployment rate). However, historically, the Fed had preferred to have the flexibility of not having an explicit target and allowing the market to interpret its comfort or discomfort with inflation – it even was reluctant to identify what measure of inflation it preferred. What we have learned, and perhaps the hard way, is that the Fed still prefers to have the flexibility of a *non-explicit inflation target* and has in fact been attempting to manage its communication in such a fashion; the Fed has acted similarly for unemployment, although there is now no official unemployment target, just a moving range (now 5.0%-5.2%) for unemployment when the economy is considered to be at full employment. Fixating too closely on targets has been misleading in terms of gauging Fed policy. And complicating matters has been the Fed's gravitation to more communication and more communicators. For example, market participants have been left wondering whose dots are relevant and if the dots are, in fact, relevant in the first place.

Recently Janet Yellen said in a speech at the University of Massachusetts in Amherst: "It will likely be appropriate to raise the target range of the federal-funds rate sometime later this year and to continue boosting short-term rates at a gradual pace thereafter as the labor market improves further and inflation moves back to our 2% objective,". Of course, investors have been guided to relate such comments to "data dependency" and, ultimately, inflation and employment. However, we think that such emphasis obscures the real decision facing the Fed, which is whether raising the Fed Funds target will threaten the economy and/or inflation. We are firmly in the camp that believes ZIRP is no longer appropriate or desirable for the economy in its current state. Nevertheless, with inflation benign, we cannot envision a scenario where the Fed would jeopardise the hard fought gains since the credit crisis by endangering capital markets and ultimately the wealth effect – the only tangible effect of forward guidance and QE.

The Canadian Economy & Bank of Canada

The depreciation of the Canadian dollar has been the main policy response (albeit implicit) to the deterioration of Canada's energy exports over the last year. Signs of traction from the weaker Loonie have been slow to materialise, although a narrowing of the trade deficit during the summer has been cause for optimism. Unfortunately, August's trade numbers show a re-widening of the trade gap, and it is difficult to foresee a consistent narrowing trend in the

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horizon. The ability of non-energy exports to respond to the weaker dollar is unfortunately limited by the absence of companies and capacity in industries formerly reliant on a weak Canadian dollar for US sales. During the 64% price decline for the WCS (West Canadian Select) oil benchmark from just over a year ago to today, the Canadian dollar has depreciated by 25 cents versus the US, but the change in manufacturing employment has been almost nil.

At the moment, consumers are the main contributor to growth in the Canadian economy. Auto sales and housing starts have been resilient, with both ahead of last year's pace by 2.5% and 1.7% respectively, despite a substantial portion of last year's activity having taken place before the fall in oil prices. Although the housing market continues to tick along, aided by low mortgage rates, consumer fundamentals have deteriorated further with household debt to income having risen to a record high of 167% (at the end of Q2). Furthermore, housing gains have been uneven across the country with the largest urban centres of Vancouver and Toronto producing the highest year-over-year price increases of over 10% versus fairly stagnant prices elsewhere.

The Bank of Canada has been relatively quiet since it cut overnight rates in July for the second time this year. We feel that the Bank is content to let the CAD-depreciation play out further (there would likely be additional currency adjustment stemming from a Fed rate hike), and is likely leery of making another move in light of the amount of consumer indebtedness. It is worth pointing out that the Bank does not have many tools at its disposal to offer further stimulus, as a Canadian version of QE would likely not result in a wealth effect similar to what took place south of the border.

Managing Corporate Bonds

The recent troubles across global markets have led to more Fed uncertainty which has translated into more capital market volatility. The VIX index is at the highest levels in 4 years and daily volatility in the US Treasury market is also high – the TYVIX index has been elevated throughout 2015 so far. Investors have reacted by shying away from risk – equity funds saw $28 billion (Investment Company Institute) in outflows during Q3. The corporate bond market has also seen its share of risk-off behaviour with the prices on high yield debt tracking those of the equity market. Investment grade credit has predictably performed better, but it has not been spared the move to safer assets. In general, liquidity in the corporate market is poor in both Canada and the US, despite suggestions by the New York Fed[1] otherwise, and in our estimation has amplified the recent corporate bond underperformance. Secondary activity is dominated by agency trading (dealers matching buyers and sellers), and thus any selling pressure will elevate liquidity risk. New issuance – a strong suit of the Canadian market over the last few years – has also become more of a challenge as investors can no longer rely on spread concessions to immediately reward the risk of new investments.

In terms of risk/reward, we consider the best opportunity in the corporate sector to be in the short term area (1-5 years) where the yield spreads account for over half of the overall yield on average. In relation to Government of Canada bonds, the

[1]The New York Fed has recently published a six part series of blog posts on market liquidity found in the Liberty Street Economics page of its website. In the first article: "Has U.S. Corporate Bond Market Liquidity Deteriorated", the authors: Adrian, Fleming, Shachar and Vogt challenge the popular assumption that corporate bond market liquidity has deteriorated. They base their analysis on bid-offer spreads on trades conducted in the US investment grade corporate market, concluding that liquidity, as defined by bid-offer spreads, has continued to improve since 2002 (though interrupted by the credit crisis). In the second article "Has Liquidity Risk in the Corporate Bond Market Increased", the authors distinguish between liquidity and liquidity risk – the frequency of large day-to-day increases in illiquidity and price volatility, and conclude that corporate bond market liquidity risk is stable.

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protection embedded in short term corporates is at the second highest level in the last ten years (see Figure 2). The highest ratio of protection between short term corporates and Canada was at the peak of the credit crisis, when risk/reward overwhelmingly favoured corporates as corporate yield spreads widened well beyond levels previously seen.

In terms of liquidity, we continue to emphasize this aspect of our corporate investments, especially in situations where we will eventually need to add to or reduce from a position. We apply a variety of screens to shrink the corporate universe down to issues whose transaction costs will be minimal. Many lower rated credits with poor liquidity measures have seen their spreads experience material widening.

In general, we feel that there is better value allocating risk in the portfolio via an overweight in the corporate bond market than by extending duration. For example, each additional ¼ year of short corporate bonds adds 19 bps in yield vs 4 bps for a ¼ year extension of the portfolio's duration by adding 10-year Canadas. We believe the fundamentals for good quality corporates (financials, utilities, etc.) are reasonable with the greatest risk coming from short term liquidity risk.

Break-even Yields

The break-even yield is the amount that yields would have to rise in a 12-month period to generate a capital loss that would offset the yield, considering a parallel shift of the yield curve and absent tax considerations.

Figure 1: Universe Index* Break-even Yields

Term	Canada (bps)	Provincial (bps)	Corporate (bps)
Short	22	38	67
Mid	18	32	46
Long	13	22	32

Figure 2: Historical Short Canada* & Corporate A* Break-even Yields

** FTSE TMX Canada Universe Bond Index*

Source: FTSE TMX Global Debt Capital Market & Lorica Investment Counsel Inc.; September 2015