LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Luckily there was so much going on during April that one really didn't have to pay inordinate attention to the generally crumby weather that dominated most of the country. From an economic perspective, the signs of a sentiment shift by investors began to emerge as fundamentals began a more obvious change in early spring. From an investment perspective: mostly bond investors, and mostly the kind not swept up by the current preoccupation with credit, seemed to notice.

April was a very healthy month for bond returns: the Barclays Capital Bond Index (formerly the Lehman Aggregate Bond Index) returned 1.27% for the U.S., while the DEX Universe Index returned 0.85% for Canada during the month. In yield terms, the unrelenting rise in yields that seemed to spook investors as notable as Bill Gross of Pimco, made an about face falling from the highs in February, as 10-year yields fell 30 and 28 basis points in the U.S. and Canada respectively. (For what it's worth some of Gross' competitors fared better with more friendly U.S. Treasury views.)

The combination of weak domestic fundamentals in the U.S. – housing and jobs, tighter monetary policies elsewhere, high commodity prices and global supply chain damage has jeopardized the consensus recovery. For those paying attention this was enough to direct more money into fixed income. For others, the signal coming out of Chairman Bernanke's press conference (first ever for a Fed Chairman) was the ingredient needed to catalyze the bond market rebound.

The sovereign debt crisis battering the European periphery continued its intrusion into the political, fiscal and monetary affairs of Europe as the ECB struggled with the direction of monetary policy while fiscal conservatives such as Finland and Germany faced more signs of political opposition to fiscal support. Although the ECB elected to raise rates in April, the future path of monetary policy is uncertain as the weaker periphery appears less able to absorb higher interest rates desired by the inflation-sensitive core.

S&P's credit downgrade to the Treasury market appeared to put the U.S. on notice that they are in danger of following the European swine. We have maintained that the U.S.'s preferred status as a place for risk-averse assets affords the U.S. more time to correct its situation, despite its dangerously large reliance on foreign investment and no clear government path for reform.

Finally, the Canadian election, thrust upon the electorate, proved to be more a diversion than most anticipated, especially the professional pollsters and pundits. Harper's majority, an opposition that will take some time to get its bearings, and an invisible Quebec sovereignist faction raises the likelihood that the government will pursue a prudent economic and bond market-friendly agenda.

Outlook & Strategy

We expect weak U.S. GDP in the second half of 2011 and a Canadian economy that will not be as resilient as in the last few years. Inflation will remain a commodity problem with relatively high unemployment preventing wholesale transmission to the broader economy.

A divided Fed will ensure an end to quantitative easing in the summer; but we don't expect rate hikes until next year. We are decidedly non-consensus with our view on the Bank of Canada – no tightening until Q4 at the earliest.

Bond yields will surprise many with their stubbornness to stay low. However, we are more cautious than most over the prospects for risk assets including equities and corporate debt.

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