LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Commentary

All things considered, the bond market held up reasonably well during February, as corporates and, to a lesser degree, provincials made up for the poor performance of federal bonds. The monthly return for the overall DEX Universe Index was 0.23% with returns of 0.04%, 0.43% and 0.46% for Canada's, provincials and corporates respectively. (Note that the Universe provincial performance was skewed by the longer duration of the Universe provincial sector relative to that of the Canada and corporate sectors.)

Although month-over-month the bond market showed little direction – 10-year Government of Canada yields moved from 3.27% to 3.29%, in our view there has been a discrete shift in sentiment as investors grapple with a host of challenging factors, both economic and other. During the month, Government of Canada 10-year yields moved within close to a 25 basis points range while similar term U.S. Treasuries moved within a 35 bps range. Given that the front end of the yield curve in both countries has been relatively well anchored volatility in 10-year and longer yields has also meant volatility in the slope of the yield curve.

Bond investors are responding to significant risks that lay in the horizon which we see as overtaking the optimism that followed the autumn Season of Stimulus. QE2 and the renewal of the Bush tax cuts did the most that could be hoped for, which has invigorated both the equity and corporate bond markets. In addition, pools of global liquidity have resulted in inflationary pressures that have emerged from emerging economies. While developing countries have responded to inflationary pressures with tightening of monetary policies, we feel there will be a more direct impact on developed countries as consumers make their adjustments to deal with higher commodity prices. Overlay the spawning Revolutions in the Middle East and North Africa, and it is not surprising that the sell-off in government bonds appears to have stalled (notwithstanding bonds of sovereign-debt challenged governments).

In Canada, the money market is currently priced for an increase of short term rates by the Bank of Canada of between 50 and 75 basis points by the end of the year. In the U.S. the Fed is expected to be on hold with no hike factored in over the same period. Interestingly, European money markets are also priced for roughly 75 bps of tightening to the end of the year, despite diffused economic growth rates and inflation expectations across the EU.

Activity

There was no portfolio activity for the month.

Outlook & Strategy

We believe that the Bank of Canada will likely not get through its 75 bps this year which presents an opportunity. Furthermore, a steeper yield curve presents opportunity for yield pickup and future flattening. For the time being we have chosen to express our view of the bond market through our substantial overweight in the 10-year part of the yield curve, believing that support for bonds will also mean flattening of the yield curve in Canada, particularly between 2 and 10-year yields. We anticipate an opportunity to increase the duration of the portfolio in conjunction of a parallel shift downwards of the yield curve.

On the credit side, we are overweight, but with more defensive provincial bonds rather than corporates. Much of our corporate weight is in shorter term high quality financials. While we have discussed in the past that corporations have generally good balance sheets, we see risks to the corporate market coming from broader concerns of sovereign debt and geopolitical events.

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