LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Commentary

North American bond markets have had a relatively rough start to the year: 10-year government of Canada and U.S. Treasury yields rose 15 and 8 basis points respectively. However, NA markets have been a little better than Core European markets where 10-year Gilts (an honorary core member and only just), Oats and Bunds rose 26, 17 and 19 bps respectively. Peripheral European bonds that were beaten up so badly in Q4 rebounded in January – Greek, Spanish, Italian and Irish 10-year yields fell 124, 22, 9 and 9 bps amidst significant volatility. Finally, Japanese yields also rose 12 basis points over the month.

Developed bond markets seem to be responding to the optimism that an economic recovery is in the visible horizon and that it is only a matter of time for it to translate into better employment and growth data. Equity markets have surely presaged this outcome.

Never-the-less moves in the yield curve reflect this increased optimism for economic prospects. In Canada the 2-10 Government of Canada yield curve steepened by 15 basis points over the month and now stands at 3.38% - a level last seen in June of last year, before the Bank of Canada began its 75 basis points rate increase from June to September.

Similarly, corporate bond markets continue to reflect the reality of healthy balance sheets and receptive investors. In Canada, corporate yield spread narrowed by an average of 5 basis points over the month. In contrast, provincial yield spreads widened by an average of 2 bp across the yield curve over the same period.

Activity

To increase the overall yield of the portfolio we have taken advantage of:

1. The steepness of the yield curve by increasing the duration of the portfolio to neutral with the benchmark and have significantly over weighted the 10-year segment of the portfolio; and
2. The flattened provincial yield spread curve between 10-year and 20-year provincials by adding 10-year provincials bonds.

To carry out the above change, Bank of Montreal 5.04% September 4, 2012 was sold to purchase Province of Quebec 4.5% December 1, 2020.

Outlook & Strategy

We still have a benign outlook for inflation in North America and most other developed countries, Germany being one possible exception. However, commodity prices will continue to impact developing countries, and the recent instability in the Middle East could very likely result in meaningfully higher energy prices. As with past episodes of spiking oil prices, we see the impact on the economy as ultimately constraining and potentially disinflationary.

We acknowledge that the post-stimulus announcement effects are still alive in the U.S., but the stubbornness of just under 10% unemployment (18% if you included marginally attached and employed workers) and the problematic housing market continue to give us reason to pause. The backdrop is better in Canada, but a significant degree of Canadian optimism is banking on a substantial U.S. recovery – not a forgone conclusion in our view.

We expect yields to be volatile throughout the year, but show little directionality. The next opportunity will be for a duration extension, as we feel investors have become too optimistic about growth prospects and perhaps not nervous enough about geopolitical events. For now we are neutral to the benchmark on a duration basis with a significant overweight in the middle of the yield curve.

The portfolio is overweight credit but from more of a defensive position. There is a significant overweight in provincials, primarily in 10 and 20 year bonds; and an overweight in corporate bonds (underweight on a duration risks basis) albeit with generally shorter maturities. Although, individual company fundamentals are largely in good shape, we see risks to current valuations

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