March 31, 2011

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

Although yields ended the quarter higher than where they started, evidence of a clear trend was scant. Returns were flat, as the increase in yields offset coupon income.

The U.S. budget has been pushed off the first page by global events. Unrest in the Middle East has caused oil prices to rise, albeit far from the debilitating levels seen prior to the debt crisis in the summer of 2008, when WTI rose to $145. However, there is no doubt in our minds that current levels will already be exerting pressure on household disposable income. Like so many of the risks to the global economy that have appeared unwittingly, the damage to the Japanese supply chain seems to have already been dismissed. Common sense tells us that industries, where Japan is still an important supplier, will be affected until Japan is able to rebuild its infrastructure.

On the U.S. front, house prices have continued to fall – the Case-Shiller Composite Home Price Index which dropped by 3.1% yoy to January. Without stabilisation in the housing market, we expect the rebound in employment to remain muted. Manufacturing has been the one bright spot in the U.S. recovery with the ISM Manufacturing Index posting its highest reading since May 2004.

In Canada, the election was the big event during the quarter, although not for any substantial economic or market reasons. It did have an impact on Bank of Canada expectations, reducing the probability of a rate hike in April.

Portfolio Activity

Jan 18- Sold position in BMO 5.04/12 and established position in Quebec 4.5/20. Increased portfolio duration to neutral relative to the index. Attractive Quebec 10YR spreads.

March 9- Increased weighting of Ontario 6.5/29. Investment of excess cash and anticipation of further long provincial spread tightening.

March 23- Purchased Royal Bank covered bond 3.77/18 and decreased weighting in Canada 3.75/19. Increased corporate exposure vis-à-vis Super senior issue. Relative value versus more subordinate issues and came at a good concession.

What Worked In The Quarter

The substantial overweight in the 10-year part of the yield curve and corresponding underweights in 3-year and longs benefitted performance as the 3 year yields rose an additional 14 basis points over 10's.

What Didn't Work In The Quarter

Our defensive posture with an overweight in provincials and slight underweight in corporates (on a risk basis) was slightly premature as provincial's underperformed corporates over the quarter

Outlook & Strategy

With the present reverberations coming from members of the FOMC, we feel there is virtually zero chance of any additional monetary support. In fact, we are inclined to bet on the vocal minority of district-Fed presidents who are calling for tighter policy action. Given that the Fed's non-conventional monetary policy has been through quantitative easing, we expect that it will direct its activities there first. Stable policy or even quantitative tightening will likely put pressure on risky assets, and perhaps some pressure on longer term government yields – the latter being more difficult to predict. We expect that a hike from the Bank of Canada will be later in the year, if at all. Although by then economic prospects could have already dimmed preventing the Bank from any rate increase.

We are reasonably optimistic for Canadian government bond yields in 2011. While a reversal of monetary policy from the Fed could exert some upward pressure on long Treasury yields, the secondary impact to long Canada's will not be as significant. Furthermore, there is a greater risk of tighter monetary policy being premature and dealing recovering economies a setback, thereby keeping a lid on bond yields, eventually forcing them lower. We are also concerned that tighter monetary policy will reduce investor enthusiasm for risky assets which will result in underperformance of credit investments.

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