FOYSTON, GORDON & PAYNE INC.

INVESTMENT COUNSEL

January 22, 2015

The Bank of Canada's January Surprise: FGP's View

The Bank of Canada (BoC) yesterday announced a surprise 0.25% cut to its target overnight rate, which now stands at 0.75%. This was the BoC's first monetary policy action since September 2010. The impact to some segments of the market was immediate as the Canadian dollar dropped considerably against the U.S. dollar and the short end of the yield curve moved noticeably lower. Interestingly, the long end of the yield curve retraced its initial declines to end yesterday unchanged.

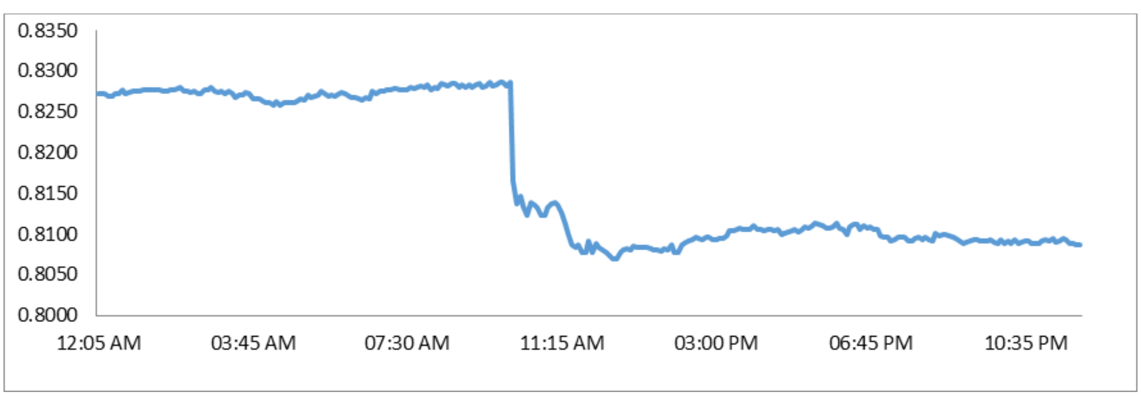
The rationale for the cut was crystal clear from the BoC. In their words, "*This decision is in response to the recent sharp drop in oil prices, which will be negative for growth and underlying inflation in Canada.*" They continued to clarify that, as result of the downside risks to growth and inflation, they felt it necessary to act now in order to "*provide insurance against these risks, support the sectoral adjustment needed to strengthen investment and growth, and bring the Canadian economy back to full capacity and inflation to target within the projection horizon*."

FGP believes there are two points to emphasize:

- The clear implication is that this move is focused less on the fixed income market and more on leveraging the currency to support economic growth. Under Governor Stephen Poloz, the focus at the BoC has progressively moved towards softening the currency to stimulate exports. We don't see this focus reversing anytime soon.

- Implying that this form of "insurance" will provide stability and confidence is somewhat counterintuitive to us. A surprise rate announcement that destabilizes the currency market only adds to long term uncertainty and is unlikely to boost business confidence. (The chart below showing yesterday's fluctuations in the Canadian dollar demonstrates that a surprise BoC move is not consistent with a market that was even remotely expecting an interest rate cut.)

The Canadian dollar on Wednesday, January 21, 2015 (CAD / USD)



Source: Thomson One

As for the risks to growth and inflation, we do not fundamentally disagree with the BoC's assessment as we have also been expecting some softening of key economic data throughout the first half of 2015. However, given that real GDP growth is 2.6% (Q3 2014) and core inflation is 2.1% (Nov. 30, 2014), we believe the long term market clearing yield (intrinsic value) for the 30-year Canada bond should be higher than yesterday's close of 2.04%.

Even if we envision a plausible short term scenario where real GDP growth drops to 1.5% and core inflation falls to 1.5%, this still implies a market clearing yield of at least 3.0% for the 30-year Canada bond. Either the economic fundamentals need to continue to decline or market pricing has to readjust with higher longer term yields. We believe in the latter outcome. Simply put, we view longer duration bonds as being too expensive, and the margin of safety is too low for a longer term investment to be profitable.

As you know, not all investments in the Canadian bond market are at the long end of the yield curve and we continue to see value in select shorter term issues. For example, given the move in the price of oil, the Energy segment of the bond market is out of favor because the risk level has changed for companies with commodity exposure. As a result, credit spreads for the whole Energy sector have widened. This is exactly the type of situation we look for as it provides the opportunity to invest in high-quality companies whose underlying fundamentals are disconnected from current market pricing.

We therefore recently added to our position in a five year bond issued by an exceptionally stable pipeline operating company in the Athabasca oil sands. This pipeline is an integral piece of infrastructure in its region, operating with long term agreements that eliminate oil price and volume risk, providing this bond with a stable and predictable cash flow profile. Furthermore, we value the security of these agreements because the counterparties are some of the largest and most highly rated diversified oil companies in the world.

We are comfortable with this investment from the basis of credit risk, duration risk, and liquidity risk. We purchased our additional position last week for an all-in yield of 2.20%. Looked at another way, we are receiving a yield 15 basis points higher than the yield on a 30-year Canada bond, yet with a 25 year shorter term to maturity.

Yesterday's policy announcement by the BoC has done little to alter our view of the overall market. There is still value in Fixed Income. We just have to be more selective in finding it.