LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

The credit markets are under stress. Negative macro developments pushed domestic investment grade spreads out on average of 28 basis points in August. While widening was not as severe as in the US investment grade and high yield space (55 and 170 basis points respectively), there was growing momentum of domestic underperformance relative to global credit markets heading into month-end.

We have spoken at length about the unique supply/demand imbalances in Canada that have resulted in an underlying bid to credit in recent years, and true to form, as credit markets internationally sold off through mid-August, Canadian spreads held relatively firm. As equity markets rebounded however, asset re-allocation flows (albeit small) could not be absorbed by neither an investor base whom is already heavily overweight corporates, nor a dealer base whom (as bank year end approaches) is in balance sheet preservation mode. As a result, while global credit markets were rallying, domestic corporate and bid/ask spreads gapped out. Liquidity, which was already thin, deteriorated further during August, so much so that a lack of a bid on higher beta names has emerged.

Amidst the price volatility and liquidity deterioration, the primary market stalled. For the month, $690 million of corporate deals came to market, well off the monthly average of $6.3 billion recorded until the end of July. A drop in issuance was also seen in the United States as investment grade and high yield deal volume fell to $48.2B and $1.0B respectively, from the monthly average of $65.2B and $28.1B this year. Domestically, new issuance consisted of three deals from Intact Financial ($300M 10YR), Calloway REIT ($90M 7YR) and Sun Life Financial ($300M 10YR).

With absolute yields at near historical lows, there was chatter of further opportunistic deals coming to market however issuers and investors are in a stalemate over new issue concessions. On the one hand, a lack of liquidity and investor appetite deems wider; while on the other, strong and liquid corporate balance sheets and moderate refinancing needs suggest issuers need not capitulate.

For the month, short, mid and long corporate yield spreads widened by 30, 37 and 17 basis points respectively, resulting in absolute returns (which account for changes in the yield curve as well as coupon income) of 0.32%, 0.27% and 0.67% respectively, according to the DEX Bond Indices. Long corporates consistently outperformed corporates of shorter maturity for the month as the long end has the lowest concentration of (underperforming) financials. Additionally, long defensive credit continues to be in demand by asset-liability managers in need of yield pick-up.

Across the yield curve, the best spread performance was reserved for defensive sectors such as utilities, infrastructure and pipelines. Financials, real estate, and retail were the worst performing sectors. Despite, relatively good Q3 bank earnings, financials performed poorly – in times of risk aversion and illiquidity jumbo (financial) issues are the most easily to get a bid on (narrowest bid/ask spreads) and hence marked to market more quickly than other sectors.

Outlook & Strategy

We believe that the corporate bond market will continue to be impacted more by exogenous events and supply, than a significant degradation in the general quality of credits. We feel there is little catalyst for significant spread tightening, and hence are not yet ready to lose our defensive bias. However, with the potential for increased volatility and event risk, we feel this presents an opportunity to capitalize on relative value and yield enhancement opportunities.

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