LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

New issuance, unresolved European sovereign concerns and a lack of a Super Committee agreement weighed on credit markets in November as investment grade spreads widened on average by 6 basis points. The widening may have been more pronounced had it not been for the month-end coordinated effort by central banks to cut rates on dollar liquidity swap lines. Upon the announcement, credit spreads gapped in significantly from their wides.

Despite negative headlines, the primary market was buoyed by built in demand stemming from the December 1st index extension and coupon payments. In total, $6.8 billion of new issuance was placed during November, which factoring in market conditions, compared favourably to the $3.4 and $7.1 billion placed last month and November of last year, respectively. After the recent deluge of Yankee market (US dollar denominated bonds issued in the US by a foreign issuer) issuance by Canadian banks, the banks returned to the domestic market with 5-year deposit note deals led by CIBC ($1.25B) and Bank of Nova Scotia ($1.3B). Other notable deals included TransCanada Pipelines (10-year and 30-year - $500M and $250M tranches respectively) and Manufacturers Life Insurance (5-year - $550M). The latter deal was the first subordinated debenture issued by Manulife in more than a decade and one of the few subordinated issues that have come to market this year.

Large and attractive new issue concessions (averaging 7-15 basis points) have begun-albeit slowly- to re-price the credit curve, yet significant discrepancies remain. On the new issue side, most deals have been well oversubscribed but unable to regain those concessions in secondary trading. Issues that have come with little or no concession have seen the bid go offside very quickly. In normal functioning markets, secondary spreads would take their lead from new issuance spread behaviour; however the secondary markets are marching to the beat of their own drum. Broker dealers concerned about liquidity are not arbitraging the corporate curve bidding only to cover short positions and offering issues at rich valuations. Alternatively, investors are cautious of buying expensive secondary market product when new issues are coming at deep discounts and with very wide bid/ask spreads and they are unable to sell positions efficiently. As a result, increased price discovery and volatility have become the norm.

For the month, short, mid and long corporate yield spreads widened by 4, 5 and 8 basis points respectively, resulting in absolute returns (which account for changes in the yield curve as well as coupon income) of 0.07%, 0.34% and 2.15% respectively, according to the DEX Bond Indices. The bear steepening seen in the credit curve was largely supply driven. Longer-term spreads were pressured by issuance from non-financial firms (infrastructure and pipelines) looking to opportunistically take advantage of strong demand for long-term credit (fills for recent deals have ranged from 10-40%) and historically low all-in yields.

Across the curve, the best spread and absolute performance was reserved for telecom and retail (no issuance and large coupon payments), media (YPG) and defensive sectors with no overhang of recent or upcoming deals (gas and electric utilities). Worst performing sectors included insurance (fundamental pressures, recent Manulife/Sun Life deals and a further Industrial Alliance issue on the horizon), mid and long term infrastructure (new issue concessions) and short/mid-term bank deposit notes (new issue supply) and subordinated issues (high beta). On a rating basis, BBB credit outperformed higher grade issues, a reflection of the fact that telecom, cable and retail constituents are all BBB rated.

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.

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