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LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

On the whole, credit markets cautiously improved in October as investment grade spreads narrowed on average by 3 basis points in October. Through mid-month, macro headlines, volatility and poor corporate performance resulted in little appetite for credit from an investor base that is heavily overweight corporates, and a dealer base whom (as bank year end approaches) appeared to be in balance sheet preservation mode. Heading into month end however, generally positive Q3 corporate earnings reports, a dearth of new issuance and more importantly, an announcement on a potential European sovereign debt resolution, led credit spreads to snap back from their widest levels.

The primary market reflected the general level of market trepidation as there was only $3.4 billion in new issuance in October. This was well off the monthly average of $5.2 billion recorded until the end of September, yet a marked improvement over the dismal $690MM and $2.3 billion issued in August and September respectively. Issuance was led by Bank of Montreal (5yr deposit note - $900M), CU Inc. (30yr and 50yr - $500M and $200M tranches respectively), George Weston (5yr - $350M) and Westcoast Energy (10yr and 30yr – $150M tranches). We also saw the first high yield deal placed since July, as Sherritt International came to market with a 7yr $400M issue. The deal was notable for its size - the largest high yield offering in a year, its large concession - 100 basis points, and its poor performance in the after-market - due to market conditions and high retail allocation.

With absolute yields at near historical lows, there was chatter of further opportunistic deals coming to market; however issuers and investors were in a stalemate over new issue concessions. On the one hand, a lack of liquidity and investor appetite warrants wider spreads; while on the other, strong and liquid corporate balance sheets and moderate refinancing needs suggest issuers need not capitulate. This tug-of-war was exemplified by the Bank of Montreal deposit note deal, which came with a hefty concession (11 basis points) and helped to deter further bank issuance domestically for the month. In place of Canada, the banks looked south of the border and a receptive Yankee (US dollar denominated bonds issued in the US by a foreign issuer) market, placing a total of $8.6 billion in fixed rate notes (covered and senior unsecured bonds).

For the month, short, mid and long corporate yield spreads narrowed by 5, 3 and 1 basis points respectively, resulting in absolute returns (which account for changes in the yield curve as well as coupon income) of -0.12%, -0.38% and -1.04% respectively, according to the DEX Bond Indices. The modest credit curve steepening from more narrowing in shorter maturities, reflected investors dipping their toes back into the corporate market through higher beta short-term bonds and the most-liquid corporates: bank deposit notes. Long-term corporates were pressured by new issuance from non-financial firms looking to opportunistically take advantage of historically low all-in yields.

The cautious market stance resulted in AA rated corporates, i.e. bank deposit notes, to generally outperform across the curve. Shorter term BBB rated corporates also performed well; however the market fortitude did not extend to longer term, higher risk corporates which as a result significantly underperformed. On a sector basis, telecom and financial issues performed well as investors looked to capitalize on recent yield spread weakness whereas insurance (fundamental concerns and negative earnings pre-announcement by Sun Life) and retail (longer term, BBB rated issues) were the worst performing 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, there should continue to be opportunity to capitalize on relative value and yield enhancement.

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