LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Corporate yield spreads were generally directionless in April, tightening by an average of one basis point. Near record levels of issuance and foreign events continue to be the main driver of spreads, although the need of investors to generate alpha is increasingly dampening volatility. For the month, short, mid and long corporate yield spreads tightened by 2, 1 and 1 basis points respectively, resulting in absolute returns (which accounts for changes in the yield curve) of 0.70%, 0.1.35% and 1.29% respectively.

Assisted by relatively lean provincial issuance – the result of provincial budget season – appetite for corporate product remained strong as new issuance totaled $5.5 billion for the month. Corporate issuance was led by two jumbo credit card securitization deals: Golden CCT $1.2 billion and Master CCT $800M and a $750M 5YR National Bank deposit issue. Noticeably absent were long non-financial issuers and the big five banks – whom instead chose to tap the Yankee market for a further $1.5 billion. This year's Yankee bank issuance (covered and senior notes) is fast approaching $10 billion.

Beyond the jumbo deals, issuance was a hodgepodge of infrequent issuers (Enersource, Home Capital Group), high-yield names (Trident Exploration, Dave Wireless) and Maples (Goldman Sachs, ANZ and Lloyds) - all of which took advantage of the backdrop that is favorable for higher-yielding, non-financial or infrequent issuers, as there continues to be a premium attached to name diversification.

The lingering effects of heavy telecom issuance in March resulted in a slight bear steepening of the credit curve through mid-month, albeit with a bull flattening into month-end as the demand/supply imbalance grew for high quality long non-financials. Higher rated credit, in particular infrastructure, utilities and transportation, outperformed. The recent rally in insurance and Tier 1 hybrids has subsided, yet the search for alpha resulted in outperformance of short-term financials. The worst spread performance was reserved for the telecom and cable sector which continues to suffer from indigestion of March's heavy issuance, rumors of further supply and increasing fundamental concerns. Weakness in the lower-rated telecom sector also weighed on high-yield spreads.

Outlook & Strategy

Although there are still many areas of economic uncertainty, domestic corporate bond market returns will be more impacted by supply, regulatory events and exogenous events, than a significant degradation in the general quality of credits. We feel that the insatiable appetite for credit as of late has been met and if the near record levels of supply continue, spreads will be materially pressured.

The biggest wildcard in our issuance forecast relates to the sector with biggest refinancing needs, financials. Slow loan growth, attractive funding levels in the Yankee market, and significant pre-funding would suggest a decline in issuance however pressures from new regulatory liquidity and funding requirements (albeit with a long phase in period) and the possible crowding out of domestic banks in international markets may result in higher domestic issuance needs.

We are increasingly concerned with the possibility of more shareholder friendly initiatives particularly via share buybacks and increased dividends. Dividend yields in many cases are much higher than after-tax debt costs. Boards are incentivized to reward shareholders their "just deserts" for years where debt concerns where of foremost concern.

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