LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

A weakening macro outlook and continued European sovereign concerns pressured corporate yield spreads wider in May by an average 4 bps. Globally, the Canadian corporate bond market performed relatively well, but the bias has definitely shifted towards spread widening and increased volatility.

For the month, short, mid and long spreads widened by 2, 5 and 3 basis points respectively, resulting in absolute returns (which accounts for changes in the yield curve) of 0.71%, 1.58% and 3.09% respectively. The credit curve (which is the spread between credit and Government of Canada yield curves) remained relatively constant through mid-month, steepening slightly into month-end as the underlying Government of Canada curve flattened despite significant demand for high quality long non-financials.

Generally, in the short-term part of the curve higher beta names (e.g. Sunlife, on the redemption of a fixed floater) and sectors (i.e. retail, financials, real estate) outperformed, whereas though the middle and long-end of the curve, higher rated credit outperformed (i.e. infrastructure, utilities and transportation sectors). The worst spread performance was reserved for media (YPG), and the telecom and cable sector which suffered from two large new issues, amidst continued indigestion of March's heavy issuance.

With a number of public companies in earnings blackout coupled with the weaker market tone, May new issuance fell to $4.6 Billion – an abrupt end of the near record issuance levels that have been seen year-to-date. Issuance was led by three large telecom deals (Bell Canada 5yr and 10yr – $500M each tranche, Telus 5yr – $600M) and one credit card securitization issue (CIBC's Cards II Trust 5yr – $600M). Outside of these deals, issuance was heavily weighted to high-yield lower rated (Connacher, Savanna Energy, Flint Energy) and unrated (Stantec, Barrett Xplore) names. The last of these deals, Flint Energy, downsized its inaugural issue from initial guidance, as high-yield sold off into month-end. Looking ahead to June, issuance is anticipated to pick up from May's subdued level as deals marketed in May come to fruition and typical bank supply following earnings blackouts materializes.

With respect to Canadian bank Q2 results, they largely continued recent trends – pressure on net interest margins, further declines in loan loss provisions and mixed capital market revenues. However, from a credit perspective operating results took a backseat to some unexpected proposals on the regulatory capital front from CIBC and National Bank. CIBC is attempting to obtain non-viability contingent capital treatment for convertible preferred shares and National Bank is attempting to exclude from phase-out non-rate-reset preferred shares. Approval of such treatment would provide a low cost substitute for regulatory compliant supply.

One other significant credit story on the regulatory front for domestic banks was the Department of Finance release of a consultation paper outlining a proposed legislative framework for covered bonds. While the covered bond market has become an important source of funding - $36 billion since 2007 and largely international - for the Canadian banks, the lack of a legislative framework has limited the investor base and increased the cost of funding.

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.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com