April 30, 2012

LORICA | INVESTMENT COUNSEL INC.

# Focused Corporate Bond

## Market Highlights

Resurgent European sovereign debt concerns and weaker than expected US economic data pushed domestic investment grade yield spreads out an average of 5 basis points (bps) in April. Amidst the elevated volatility, market participants were keen to watch from the sidelines and bid/ask spreads drifted wider in sympathy with the general pullback in risk.

The lack of market conviction was reflected in the primary market which saw only $4.8B in new issues come to market, concentrated in the first half of the month – materially less than the $5.5B and $6.5B issued in April 2011 and 2010 respectively. A growing trend was for new issues concessions to be quickly realized as soon as new issues were free to trade, placing pressure on post deal spreads.

Sizeable issuance emerged from Royal Bank ($1.5B 5yr deposit note), National Bank ($1B 5+5yr subordinated debt), Brookfield Asset Management ($425M 7yr) and 407 ETR ($400M 30yr). The subordinated debt deal from National Bank was notable as it was the first subordinated debt deal from the *big six* banks since March of last year. The deal may also prompt other banks to issue subordinated debt in the coming months, in advance of 2013 after which only subordinated debt with non-viability contingent capital features may be issued.

April also brought the announcement of the long-awaited covered bond legislation by the federal government. While the covered bond market has become an important source of funding - $63B since 2007 and largely international for the Canadian banks, the lack of a legislative framework has limited the investor base. Notably, the new legislation also prohibits the use of insured mortgages in covered pools which is significant given that insured pools comprise eighty-five percent of outstanding covered bonds and provide the issuer a 10-15 bps funding advantage over uninsured pools.

For the month, short, mid and long-term corporate yield spreads widened by 3, 5 and 7 bps respectively, resulting in absolute returns of -0.08%, 0.26% and -0.01% respectively according to the DEX Corporate Bond Index. The credit curve steepened on the back of waning relative demand for long-term credit (spreads were at unattractive levels versus provincials/municipals and on a standalone risk/reward basis), and continued, albeit softer, demand for higher beta short and mid-term issues such as subordinated bank debt.

Sector performance reflected the steepening of the credit curve as the best short and mid-term performance was reserved for higher beta sectors and instruments (i.e. insurance, and retail and bank subordinated and hybrid debt) whereas defensive sectors (utilities and pipelines) outperformed in the long-end. On a rating basis, BBB rated debt generally outperformed higher rated debt across the credit curve, aided by relatively wider initial spreads and larger coupons.

## Outlook & Strategy

Corporate fundamentals in terms of leverage, liquidity and profitability remain sound. In the near term we do not expect any significant degradation in the general quality of credit or any significant deviation from conservative corporate policies.

We feel that despite the recent (and not unexpected) uptick in tolerance for risk displayed by the credit markets, a certain level of caution is still warranted. Recent economic data has buoyed optimism yet significant hurdles both in respect to the European sovereign debt crisis and the North American economy remain. One can't ignore the eerie parallels of the first quarter rally in credit to the rallies in 2010 and 2011, when credit spreads narrowed to the tightest levels of the year in March, only to subsequently widen on the back of macro and European sovereign debt crisis concerns. The corporate bond market will continue to be impacted more so by exogenous events and supply than fundamentals. However we feel the potential for increased volatility and event risk presents an opportunity to capitalize on relative value and yield enhancement trades.

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