LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

August was an upbeat month for corporate bonds as investment grade spreads tightened by 9 basis points. Inflows into corporate bond markets (both domestic and foreign) could not be satiated by scarce primary issuance, thin dealer inventories heading into bank year-end, and light secondary activity. Although sanguine corporate earnings reports, signs of improving US economic data and chatter of an ECB bond buying program, would suggest a "grab for yield" and higher-yielding, higher beta sectors and issuers outperforming, this was not to be the case as hesitant buyers focused on liquidity and relative value.

With dealers biased to act as agents rather than principal traders (i.e. less willing to take on inventory positions), bid/ask spreads remained wide and secondary volumes remained low (down 26% from August of last year). Impelled corporate buyers thus looked to the new issue market, where spread concessions provided the opportunity to pick up credit at secondary market bid side levels. Unfortunately the new issue market proved to be somewhat of a futile hunting ground as issuers, particularly the much loved non-financials, did not feel the need to opportunistically re-finance upcoming maturities early or augment their already hefty cash stockpiles.

In August, a total of $1.6B in investment grade deals came to market – significantly higher than the $700M seen from crisis ridden August 2011 but less than the $3.5B issued in August 2010. The number was also disappointing as it coincided with a record for global corporate bond sales in August and came after a series of monthly records for domestic issuance. Issuance consisted of two long deals from Hydro One ($235M re-opening of 50YR) and Enbridge Inc ($400M 30YR) and two deposit note issues from National Bank ($750 5YR) and Bank of Nova Scotia ($250M re-opening of 2YR). Although the long deals had a modest number of buyers (15 for Hydro One and 30 for Enbridge), the Enbridge issue was its largest long deal issued to date.

For the month, short, mid and long-term corporate yield spreads tightened by 11, 9 and 6 basis points respectively, resulting in absolute returns of 0.39%, 0.48% and 0.07% respectively according to the DEX Corporate Bond Index. The credit curve steepened, (shorter term yield spreads fell relative to longer term spreads) as investors expressed a preference for shorter-term credit. Currently, long-term credit spreads, particularly for riskier sectors, appear unattractive relative to provincials and municipals, and on a standalone risk/reward basis.

On a sector basis, the best performance was reserved for banks – jumbo deposit notes and subordinated issues which act as liquid credit proxy until further primary issuance, and earnings were uneventful; insurance – relative value and few negative surprises in recent results; and telecom – continued tightening from overhang of issuance that never materialized in the late spring. Lower rated and less liquid sectors like real estate and retail underperformed. Rating performance mirrored the broad sector moves as AA rated debt outperformed across the credit curve as it is overwhelmingly comprised of senior bank debt.

Outlook & Strategy

The corporate bond market will continue to be impacted more so by supply and exogenous events than corporate fundamentals which 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.

Increased volatility and event risk present an opportunity to capitalize on relative value and yield enhancement. We however feel that investors are increasingly becoming complacent on a risk/reward basis in their reach for yield and that a certain level of caution is still warranted as significant headwinds both in respect to the European sovereign crisis and North American economy remain.

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