LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Buoyed by the persistence of a strong underlying demand for credit, domestic investment grade spreads tightened by 11 basis points in February. The demand for credit reflected an elevated interest in risk assets globally with seasonal factors such as cash inflows and beginning of year increase in risk appetite also buttressing domestic demand. The momentum of spread tightening waned into month end as investors re-evaluated the speed and extent of the rally, leading to less outright buying of corporate credit and a greater focus on relative value trades. One couldn't also ignore the eerie parallels of this recent rally to the credit 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 concerns and Europe's sovereign debt crisis.

Robust demand and historically low rates brought out opportunistic issuers and led to another record month of new issuance. In total, $8.4 bln in investment grade issuance came to market – significantly higher than the $6.0 bln and $3.7 bln issued in February 2011 and 2010 respectively. Not surprisingly, most new deals were upsized, new issue concessions narrowed, and the number of participants increased, as crossover investors returned to the fray. The bullish tone weakened into month-end as new issues concessions were increasingly monetized (issues sold back out) when they became free to trade, placing pressure on post deal spreads.

Notable issuance emerged from the more recently unloved insurance sector (Manulife and Sunlife 5-year sub debt – $500 mln and $800 mln respectively) and auto sector (Ford $500 mln, BMW $450 mln, and Toyota $400MM). After an eight month hiatus, February also saw the Maple market brought back to life with issues from IBM ($500 mln, 5-year), BP Capital Markets ($500 mln. 5-year) and Transurban Finance ($250 mln, 7-year). In the same vein, Wells Fargo Finance Canada came with an upsized jumbo $1.5B 5-year deal (initially advertised as $750 mln) that flooded investors who had padded their orders.

For the month, short, mid and long-term corporate yield spreads tightened by 11, 12 and 9 basis points respectively, resulting in absolute returns of 0.17%, 0.55% and 0.30% respectively, according to the DEX Corporate Bond Index. The credit curve steepened as a result of waning relative demand for long credit – the byproduct of a backup in underlying long-term government yields, a rally in long defensive credit that looked a little over done, and retail RSP driven demand that is typically focused on mid and short-term credit.

With the risk rally in full mode it was no surprise that across the yield curve the best spread and absolute performance was reserved for higher beta sectors and instruments. Insurance, financial services, retail and bank subordinated and hybrid debt, which lagged last year, were the best performers. Alternatively, defensive sectors such as infrastructure and utilities modestly underperformed. Relative performance on a rating basis reflected the sector moves as higher rated AA/A debt (insurance and subordinated bank debt) outperformed in the short-end of the curve, whereas in the mid-term and long-end of the curve BBB rated credit led.

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 do however 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 crisis and North American economy remain. 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.

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