LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

January saw domestic investment grade spreads tighten by 10 basis points on the back of the annual *beginning of year increase in investor risk appetite*, and continued demand for yield, given expectations for an extended period of low rates. The momentum of spread tightening increased into month-end as the market focused less on macro concerns and Europe's ongoing crisis, and more on rising equity markets and the continued solid fundamentals underpinning corporate credit.

Reduced risk aversion coupled with attractive new issue concessions, proved to be a combination too alluring for investors to resist, resulting in record January investment grade issuance of $7.4 B – materially higher than the $6.0B and $4.3B issued in January 2011 and 2010 respectively. Jumbo deposit note deals emerged from RBC ($1.1 B 3-year), CIBC, HSBC and National Bank (each $1 B, 3 to 5-year). Other bank issuance included a $1B issue from Master Credit Card Trust (BMO sponsored credit card ABS) and a smaller $250M, 5-year deposit note issue from Canadian Western Bank. Notably, one bank that didn't take any advantage (although heavily rumoured) of domestic appetite and comparatively cheap $C levels (relative to $US levels) was the Bank of Nova Scotia, which issued a hefty $4.75B in deposit notes and covered bonds in the Yankee market. Beyond these jumbo deals, issuance was a mix of retail orientated issues (Brookfield Office Properties, RioCan REIT) and US financial service issuers (GE Capital Corp and John Deere) whom were opportunistically taking advantage of the demand for yield.

For the month, short, mid and long-term corporate yield spreads tightened by 10, 10 and 9 basis points respectively, resulting in absolute returns according to the DEX Corporate Bond Index of 0.56%, 1.39% and 1.60% respectively. The credit curve marginally steepened, driven by demand for both higher beta short-end issues (bank subordinated financial service debt) and interest in longer-term defensive, non-financial issuers (infrastructure and utilities). The moves were a reflection of a still very cautious investor base that continues to be selective in terms of its exposure to corporate credit.

Across the yield curve the best spread and absolute performance was reserved for telecom (higher yielding with defensive characteristics), short and medium term dated bank subordinated and hybrid debt (reach for yield and beta) and longer-term defensive sectors (infrastructure and utilities). Insurance (fundamental concerns), energy (Encana given weak natural gas prices) and pipelines (Pembina acquisition of Provident Energy) were the standout laggards. On a ratings basis, BBB credit generally outperformed through the short and mid-term part of the credit curve, whereas in the long-end of the curve AAA/AA rated credit outperformed.

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 entirely unexpected) uptick in tolerance for risk displayed by the credit markets, a certain level of caution towards credit 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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