LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Investment grade spreads tightened by an average of eight basis points in July (DEX Corporate Bond index), buoyed by brisk corporate bond inflows, while largely shrugging off any concerns that a deteriorating macro picture will impact credit quality. The momentum of spread tightening waned into month-end, as European sovereign debt concerns resurfaced. ECB rhetoric suggesting the debt crisis would be contained and the Euro would be preserved were not enough to satisfy investors looking for concrete action.

Given the level of uncertainty in the markets and corresponding volatility, secondary activity was muted during the month. Bid/ask spreads remained wide reflecting limited dealer appetite to take on more inventory. Corporate buyers thus turned to the new issue market, where spread concessions provided the opportunity to pick up credit at prices equivalent to secondary market bid side levels. Robust demand and historically low rates brought out opportunistic issuers and led to a record for new issuance in July. In total, $6.9 billion in deals came to market – significantly higher than the $5.1B and $5.8B issued in July 2010 and 2011 respectively. Predictably, most new issues were upsized and priced on the tight side of pre-trade guidance with an increase in the number of participants, as crossover investors, fearing further equity market losses, returned to the fray.

Issuance was led by three jumbo senior debt bank deals: $1B BNS 3-yr, $1B RY 5-year and $1.5B Wells Fargo Finance Canada 7-yr, and a $1.5B 5+5-yr (fixed/floating) subordinated debt deal from BNS. Other notable issuance included an inaugural issue from PowerStream – $200M 30-yr, the first issue of size from Horizon Holdings – $150M 10-yr, and two long issues driven by reverse inquiry – $75M Hydro One 50-yr and $100M Enbridge Pipelines 100-yr. The Enbridge Pipelines “century” bond, which was sold to a single fund with long-term liabilities (presumably an insurer or pension fund) with a yield of 4.10%, was the first domestic “century” bond to be issued since a $50M Nova Scotia Power bond was sold in 1997.

For the month, short, mid and long-term corporate yield spreads tightened by 10, 9 and 5 basis points respectively, resulting in absolute returns of 0.42%, 0.90% and 1.90% respectively (DEX Corporate Bond Index). The credit curve steepened on the back of a flattening Canada curve and relatively less demand for long corporates – spreads were at unattractive levels versus provincials/municipal spreads and on a standalone risk/reward basis).

On a sector basis, the best performance was reserved for higher yielding sectors and instruments (insurance, telecom and bank subordinated debt) whereas defensive sectors (utilities and pipelines) and lower-rated, higher beta sectors (real estate, energy and retail) underperformed. Rating performance mirrored the broad sector moves as A-rated debt outperformed across the credit curve as it presented hesitant buyers the best risk/reward proposition.

Outlook & Strategy

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