LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Persistent European sovereign debt concerns and a deteriorating global macro outlook pressured corporate yield spreads wider in May by an average of 10 basis points. The spread widening is eerily reminiscent of the credit rallies in 2010 and 2011, when credit spreads narrowed to the tightest levels of the year in March, only to subsequently widen thereafter.

Liquidity is always the first casualty of risk aversion and amid the elevated volatility, market participants were keen to watch from the sidelines. As a result, bid/ask spreads drifted wider in sympathy with the general pullback in risk. This has made it cost prohibitive for an investor base (which is heavily overweight corporates) to "lighten up" on their exposure. Trading volumes - albeit overwhelmingly biased towards the selling of credit - have not been large enough to severely impact spreads.

In contrast to the secondary markets, new issuance volumes remained resilient. Aided by a heavy maturity schedule, large coupon flows, attractive spread concessions and issuers incentivized to lock in record low financing, May saw $9.8B in new deals come to market. This marked the highest May issuance on record.

Issuance was led by four $1B bank deposit note deals (RBC BNS, CIBC and HSBC), $1.1B from Rogers Communications ($500M 5yr and $600M 10 tranche), $1.1B in project finance issues (Capital City Link, 407 East Development and Centre Street Trust) and $750M from Caterpillar Financial Services ($450M 5yr and $300M 3yr tranches). Growing risk aversion was apparent as new issue concessions increased though the month, beginning from next to nil at the start of the month to topping 15-20 basis points by month-end. Likewise, investor participation per deal has declined to an average of 20-30 buyers versus 40-50 earlier in the year. Given the poor performance of recent deals, issuers will be pressured to sustain large new issuance concessions in the near term.

For the month, short, mid and long-term corporate yield spreads widened by 11, 10 and 8 basis points respectively, resulting in absolute returns of 0.84%, 1.83% and 3.46% respectively according to the DEX Corporate Bond Index. With respect to the credit curve the best short and mid-term performance was reserved for generally higher beta sectors and instruments – insurance and retail and bank subordinated and hybrid debt, with relatively wide spreads and larger coupons. The fortitude for risk did not extend to the longer-term area of the credit curve as defensive sectors – utilities, pipelines and infrastructure, outperformed. The worst performing sectors were secured for telecom and cable due to the prospects for supply in late month and bank deposit notes, a liquid credit proxy and also with supply pressures.

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; however we feel that a certain level of caution is still warranted as significant headwinds, both in respect to the European sovereign debt crisis and the North American economy, remain.

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