LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Corporate bonds continued to be an attractive asset class for investors in November as credit spreads were marginally tighter despite disappointing economic data, weakening earnings forecasts, aggressive debt issuance and unresolved European and US fiscal issues.

While counter intuitive from a fundamental perspective, the allure of yield has proven too irresistible for domestic investors to resist given a backdrop of prolonged central bank easing and equity volatility. Activity in the month was further buoyed by the embedded demand stemming from the December 1st index extension and coupon payments. There are signs of the parallels between the askew demand/supply dynamics today and those preceding the credit crisis which eventually led to falling issuer quality, increased tenors, and a lack of covenants on new issues.

Primary market investment grade issuance for November totaled $4.5 billion and while healthy, this was well of the $6.8 billion and $7.1 billion placed in November of 2011 and 2010 respectively. The reduced supply reflected the fact that there were no domestic bank issues (banks were in a self-imposed earnings black out period) and few borrowers had maturities to refinance. Of the issuance that did emerge, almost half was from opportunistic issuers with BBB rated credits who managed to lock-in their lowest all-in yields to date. These issuers included Reliance LP ($375 million 5-year and $350 million 7-year), Cameco ($400 million 10-year, $100 million 30-year), Aimia Inc ($200 million 6-year) and Cominar REIT ($200 million 7-year). Notable supply also came from 10-year utilities/pipeline names – Altalink LP ($275 million), Enbridge Inc. ($350 million), Enbridge Piplelines ($150M), CU Ltd ($200 million) and Westcoast Energy ($250 million) – which were unusually trading at or through provincial credits in this area of the yield curve.

For the month, short, mid and long-term corporate yield spreads tightened by 3, 0 and 1 basis points respectively, resulting in absolute returns of 0.42%, 0.82% and 1.56% 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 and the relative unattractiveness versus provincials and municipals (particularly for riskier sectors). On a sector basis, the best performance was reserved for higher yielding sectors and instruments (insurance and subordinated bank debt) whereas an overhang from heavy supply weighed on utilities, pipelines and autos. On a rating basis, A-rated debt (insurance and financials) outperformed in the short and mid area of the credit curve whereas BBB-rated credit outperformed in the longer end, due to defensive credit marginally underperforming.

Outlook

In terms of corporate fundamentals, leverage, liquidity and profitability remain sound. In the near term, while we do not expect any significant degradation in the general quality of credit or any significant deviation from conservative corporate policies, we do feel credit ratings may come under some pressure.

We expect credit markets to continue to receive the support of central banks. Both the Fed and the ECB have put in place policies that should sustain demand for corporate bonds, despite broader policy and economic uncertainty. We do feel however, 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 remain.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com