



LORICA | INVESTMENT
COUNSEL INC.

Focused Corporate Bond

Market Highlights

Bouyed by the persistent strong underlying demand for credit, domestic investment grade yield spreads tightened by a couple of basis points in October. The reach for yield, given the expectations for an extended period of low rates, continued to underlie demand despite the backdrop of deteriorating corporate fundamentals and near record issuance. The momentum of spread tightening waned into month-end however, as equity markets turned negative, Super-storm Sandy bore down on the Eastern Seaboard, and domestic banks were in capital preservation mode heading into fiscal year-end.

Robust demand for higher beta product enticed lower-rated, opportunistic issuers to come to market and led to an impressive \$9.5 billion in investment grade supply for the month. This was the highest level of corporate issuance for an October since 2007. Not surprisingly, most new deals were upsized, new issue concessions narrowed, and the number of participants increased, as equity investors crossing over into fixed income were active. However, unlike past periods of large supply, there was not outright buying by traditional fixed income investors. Instead, a trend developed whereby lower beta product was switched into higher risk new offerings, which provided incremental yield pick-up while not breaching corporate weighting constraints. The bullish tone weakened into month-end as the monetization (issues sold back out to the market) of increasingly smaller new issue concessions placed pressure on post-deal spreads.

Jumbo issuance emerged from the domestic banks in the form of three deposit note deals (BMO \$1.5 billion 3-year, CIBC \$1.25 billion 5-year and Caisse Centrale Desjardins \$800 million 4-year) and two sub-debt issues (BNS \$1.75 billion 7-year and Laurentian Bank \$200 million 5-year). Bank of Nova Scotia and Laurentian Bank took the opportunity to pad their Tier 2 capital levels before January 1 of 2013, after which only contingent capital sub debt subject to non-viability (Basel III) can be sold. Notable supply also came from Alimentation Couche-Tard, which issued an inaugural \$1 billion

domestic issue, through a three tranche deal (\$300 million 5-year, \$450 million 7-year and \$250 million 10-year). The BBB rated deal, which was originally intended to be issued south of the border to meet U.S. dollar financing needs, was lured home by cheaper financing. Beyond the aforementioned Laurentian Bank and Couche-Tard issues, October saw a number of BBB rated deals including Holcim Finance (\$300 million), Brookfield Infrastructure (\$400 million), Fairfax Financial (\$200 million), Pembina Pipelines (\$450 million), and Equitable Group (\$65 million).

For the month, short, mid and long-term corporate yield spreads tightened by 2, 2 and 0 basis points respectively, resulting in absolute returns of 0.17%, 0.23% and -0.56% 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, particularly for riskier sectors, when compared to provincials and municipals. On a sector basis, the best performance was reserved for higher yielding sectors and instruments (telecom, insurance and retail), whereas an overhang from heavy supply weighed on domestic bank senior and sub debt. Rating performance mirrored the broad sector moves as BBB rated debt outperformed across the credit curve.

Outlook

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, 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 pressure.

We also 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.