LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

The demand driven rally in the domestic corporate market lost some steam in April causing corporate spreads to widen modestly, by 2 basis points. The weakening, which diverged from the rally for both credit and equity south of the border, was the result of waning inflows and indigestion from heavy issuance in Q1 here at home. With no clear consensus on where corporate rates are heading in the short-term, the complacency trade –holding higher yielding corporates in a reach for yield - continues to be in vogue.

The cautious market tone was reflected in the primary market which saw only $3.6B priced – a significant drop from the $10.2B issued in March and materially less than the $4.8 issued in April of last year when European sovereign debt concerns were front and center. From a supply perspective, there was less need for issuance for several reasons including: many issuers having already opportunistically prefunded upcoming maturities; a weak macroeconomic environment which does not warrant excess funding; and many issuers being in a blackout period prior to the publication of their Q1 earnings results. For those new issues that did materialize, they were met with abnormally tepid demand and therefore required modestly larger spread concessions; few new issues performed well in the secondary markets. There was also a notable lack of benchmark sized (>$500M) deals.

In April, we saw M&A deals announced by Rogers Communications, CIBC, General Electric, Hydro One, and Shaw Communications. Rumours involving Manulife Financial and Telus also made the round of media outlets. While none one of the deals were significant enough to materially impact credit metrics or bond spreads, they did highlight that current supportive credit conditions have increased the event risk of non-bondholder friendly actions.

For the month, short, mid and long-term corporate yield spreads widened modestly, by 1, 3, and 1 basis points respectively, resulting in absolute returns of 0.43%, 1.28% and 2.16% respectively, according to the DEX Corporate Bond Index. The belly or middle of the credit curve gave back some of its relative outperformance year-to-date versus shorter and longer dated maturities. Mid and longer-term credit remained under pressure given their unattractive trading levels versus provincials and municipals.

Across the yield curve the best spread and absolute performance was reserved for lower-rated, defensive names with higher coupons, i.e. non-regulated energy, pipelines and infrastructure. The next best performers were higher yielding and higher beta issues in the telecom, retail and real estate sectors. Financials modestly underperformed due to an overhang of domestic supply in March followed by relatively cheap Yankee (Canadian issuer US dollar denominated bonds) bank issuance in April. Relative performance on a rating basis reflected the sector moves as lower-rated BBB debt generally outperformed across the credit curve.

Outlook

We 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 in respect to the global economy remain.

While we do not expect any significant degradation in the general quality of credit as corporate fundamentals, which in terms of leverage, liquidity and profitability remain sound, we do feel that at current levels investors would not be adequately protected should we see an abrupt departure from current Fed policy or some other cause of a flight to less risky assets. Alternatively, we also feel that a more upbeat economic outlook may induce investors to rotate further into equities, while prompting issuers to deviate from conservative corporate policies, both with the potential of reversing some recent spread tightening.

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