August 31, 2013

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Intensifying Fed Tapering concerns, coincident with increased geopolitical anxiety and an expected busy September new issuance calendar caused corporate spreads to widen by 3 basis points on average for the month. Generally, investors had a preference to both reduce exposure to longer maturities and improve overall credit quality.

As we have previously highlighted, rising yields accompanied by an improving economic outlook would typically result in a contraction of corporate spreads and shorter-term, lower rated, higher beta issue-outperformance. So far in this episode of rising yields, riskier issues have underperformed, highlighting the extent to which supply/supply imbalances created by QE have distorted risk-adjusted valuations.

Summer doldrums and capital constricted dealers, preferring to act as agents rather than principal traders (i.e. less willing to take on inventory positions) have resulted in lower secondary volumes and wider bid/ask spreads. Corporate buyers thus looked to the new issue market, where spread concessions provided the opportunity to pick up issues at secondary market bid-side levels. For the month, $4.2 billion in new issues came to market – a record for the month of August. Banks comprised the bulk of issuance with three deposit note issues from National Bank ($750 million 5-year), TD Bank ($1.5 billion 4-year) and Bank of Nova Scotia ($750 million 5-year). The deposit note deals were somewhat unexpected as they came during the bank earnings-related blackout period. Despite generous spread concessions, new issues generally performed poorly in the after-market.

For the month, short, mid and long-term corporate yield spreads widened by 3, 4 and 2 basis points respectively, resulting in absolute returns of -0.12%, -0.67% and -1.38% respectively according to the DEX Universe All Corporate Bond Index. The credit curve modestly bear-flattened (short term yield spreads rose more than longer term yield spreads) as the long-end was marginally supported by asset-liability managers who acquired cheaper issues due to the back up in underlying government yields.

Across the yield curve the best spread and absolute performance was reserved for insurance (sustained back up in rates to ease pressure on discount rates) and energy and pipelines (concerns over Syrian intervention). Telecom and cable (threat of Verizon as new entrant), retail (M&A activity) and real estate (supply overhang and credit metrics negatively impacted by higher rates) underperformed. On a ratings basis, increased risk aversion resulted in lower rated BBB generally underperforming across the yield curve.

Outlook & Strategy

Investors continue to be predisposed to the yield carry trade; however with the prospect of Tapering on the horizon, they appear less inclined to do so through higher beta sectors and issues, which have notably underperformed in this recent bout of rising rates.

From a credit quality perspective, the sector impacts of higher rates will be muted as yields are merely transitioning from an ultra-low to a low interest rate environment. 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.

That said, the portfolio is structured defensively and has minimal exposure to sectors or issuers that are negatively impacted by higher interest rates. We therefore are well positioned to capitalize on relative value and yield enhancement opportunities as they present themselves.

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