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LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Against a backdrop of heightened event risk and a growing chorus of pundits declaring corporate bonds (particularly those with lower ratings) to be overvalued, investment grade spreads continued their grind tighter with another 2 basis points of narrowing in February. From a credit perspective, fourth quarter earnings and guidance were innocuous, for the most part, despite concerns over future margins and the increased rhetoric on shareholder friendly initiatives. Earnings misses, ratings downgrades, lowered guidance, aggressive dividend increases and share buybacks had little impact on credit spreads.

The new issue market slowed considerably in February, after a very active January, with only $2.5 billion in investment grade credit placed. The issuance was well off the $8.4 and $6.0 billion priced in February 2012 and 2011 respectively. The slowdown in new issuance was a global phenomenon which was a product of the light maturity schedule and weak macroeconomic environment which ultimately did not warrant excess funding. Canadian issuance was further hampered by a lack of bank issues from the domestic players who were in a self-imposed earnings black-out period. The most notable issuance from a Canadian firm could be found south of the border, where, after a four year absence, Rogers Communications issued a $1 Billion U.S., U.S. dollar bond through a two tranche (10 and 30 year) deal, issued at significantly tighter yield spreads than could have been achieved in Canada. The funding arbitrage caused Roger's Canadian yield spreads to narrow in sympathy.

For the month, short, mid and long-term corporate yield spreads tightened by 2, 3 and 2 basis points respectively, resulting in absolute returns of 0.86%, 1.52% and 1.37% respectively according to the DEX Corporate Bond Index. After flattening in January, the credit curve remained unchanged in February as the demand for long credit waned. Defensive corporates are now at less attractive levels when compared to provincials and municipals and when evaluated in the context of retail RSP driven demand which is typically focused on mid and short-term credit.

The best corporate returns were found in higher yielding, higher beta sectors and instruments, where the yield spread narrowing was also the greatest. Insurance, real estate, telecom and bank subordinated and hybrid debt were the best performers. Alternatively, defensive sectors such as infrastructure and utilities modestly underperformed. Relative performance on a rating basis reflected the sector moves as higher rated AA and A credit (insurance and subordinated banks) outperformed in the short and long-end of the yield curve, whereas in the mid-term of the yield curve BBB rated credit led.

Outlook

In the short term we see few catalysts to alter the, now engrained, event-risk driven investment behavior of the credit markets. 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 North American economy and European sovereign credit crisis remain.

While we do not expect any significant degradation in the general quality of credit as corporate fundamentals, in terms of leverage, liquidity and profitability remain sound, we do feel that at current levels investors would not be adequately protected in a flight to safety scenario. Alternatively, we also feel that a more upbeat economic outlook has the potential to mitigate further corporate spread tightening through a further rotation into equities or a significant deviation from conservative corporate policies.

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