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LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

In the wake of a compromise in Washington to avert the fiscal cliff, corporate yield spreads jump started the New Year by tightening an average of 7 basis points in January. While general risk appetite immediately following the euphoria of the fiscal cliff agreement appeared strong – as demonstrated by the move in equity and volatility indices – investment grade credit traded in a relatively narrow range for the remainder of the month and stalled into month-end. The lack of a follow through rally in corporate bonds can be attributed to profit taking, heavy new issuance indigestion, a focus on new issuance versus secondary markets, mixed macro data (notably US GDP) and benign fourth quarter earnings and guidance. From a credit perspective company reporting was relatively innocuous and thus did little to alter the now ingrained event-risk driven investment behavior of credit investors.

Positive market sentiment which coincided with the annual beginning of the year increase in investor risk appetite, coincided with record issuance globally. High yield issuers, in particular, were keen to lock-in historically all-in yields, while the "dash for trash" remained in vogue. Canadian issuance followed the global trend with $9.4 billion of investment grade deals priced during January, materially surpassing the previous record of $7.4 placed during the same month last year. Jumbo note deals emerged from BNS ($1.25 billion 5-year), National Bank ($750 million 3-year), HSBC ($1.25 billion 7-year) and Bank of Montreal ($500 million 5-year reopening). Notable issuance also came from the Maple sector (Canadian dollar foreign issuers) which had its fastest start since 2006 as a total of $1.85 billion was issued from AB InBev Finance Inc. ($1.2 billion two tranche deal) and Goldman Sachs ($650 million).

For the month, short, mid and long-term corporate yield spreads tightened by 5, 8 and 7 basis points respectively, resulting in absolute returns of 0.13%, -0.15% and -1.22% respectively according to the DEX Corporate Bond Index. The credit curve flattened as a backup in underlying government bond yields increased the relative attractiveness of higher yielding corporate bonds. On a sector basis, the best performance was reserved for: insurance – higher beta retracement of relative underperformance versus financials; lower-rated sectors – energy exploration/generation and real estate; and communications – positive sale of assets by Shaw albeit offset by Cogeco concerns. An overhang of supply and rating downgrades did however, weight on senior and subordinated bank debt. On a ratings basis, A-rated credit (insurance) outperformed in the short area of the yield curve whereas BBB-rated credit outperformed in the middle and longer end of the yield curve due to investors' reach for yield.

Outlook

The corporate bond market will continue to be impacted more so by exogenous events and the demand/supply disequilibrium than corporate fundamentals which in terms of leverage, liquidity and profitability remain sound. In the medium term, we expect the Canadian economy to muddle along with greater while we do not expect any significant degradation in the general quality of credit, we do feel that a more upbeat economic outlook has the potential to mitigate further corporate spread tightening through a rotation into equities or a significant deviation from conservative corporate policies.

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 crisis remain.

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