LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

On the back of reassuring comments from the Fed, investors resumed their reach for yield in July, causing corporate spreads to tighten by 2 basis points on average for the month. The move can be most aptly described as tepid as the spread tightening stemmed from a modest extension out the credit curve, with a focus on yield pickup, versus a migration along the credit spectrum.

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

With renewed interest in corporate bonds and muted secondary activity (the result of seasonality and capital constricted dealer inventories), buyers turned their attention to the new issue market, where new issue spread concessions provided the opportunity to pick up credit at prices equivalent to secondary market bid-side levels. In total, $7.6 billion in deals came to market – a record for the month of July. Notable issuance emerged from Royal Bank ($2 billion 5-year deposit note), Sobeys ($1 billion across two tranches), TransCanada Pipelines ($750 million across two tranches) and six deals from real estate issuers totaling $1.4 billion. Given strong investor appetite and the anticipation of higher rates, we foresee issuance to remain buoyant as issuers look for opportunities to term out bank debt, pre-fund upcoming maturities or refinance callable bonds.

For the month, short, mid and long-term corporate yield spreads tightened by 1, 4 and 2 basis points respectively, resulting in absolute returns of 0.53%, 0.71% and 0.08% respectively according to the DEX Corporate Bond Index. The middle area of the credit curve outperformed as investors modestly increased duration to increase yield pick-up. The long-end of the credit curve also continued to perform well as the recent backup in underlying government yields provided an opportunity for asset-liability managers to pick up cheaper issues.

Across the yield curve the best spread and absolute performance was reserved for telecom and cable – receding concerns related to Verizon's prospective entrance, and bank deposit notes – preference for high-rated, liquid issues. The weakest performers were retail – M&A activity, and real estate – supply overhang and weaker credit metrics due to higher yields. Relative performance on a rating basis reflected the sector moves as higher rated AA/A debt (largely bank debt) outperformed in the short and long-end of the yield curve, whereas in the mid-term of the curve BBB rated credit (particularly telecom and cable) led.

Outlook

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 in this recent cycle of rising rates have notably underperformed).

From a credit quality perspective, the sector impacts of higher rates will be muted given that 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 will be 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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