LORICA | INVESTMENT COUNSEL INC.

# Focused Corporate Bond

## Market Highlights

The demand driven rally witnessed in the corporate market through most of Q2 came to an abrupt halt with the prospect of an end to quantitative easing (QE). The result being that after tightening by 4 basis points through the end of May, corporate spreads widened by 9 basis points during June. While the extent of spread widening was notable, it was minor in comparison to the move south of the border where corporate spreads widened to as much as 30 basis points as rumblings of a QE endgame emerged. The divergence stems from a variety of factors including: different investor bases (buy-and-hold versus levered *fast money*), continued fund flows into Canadian fixed income (via balanced funds), and a less liquid Canadian corporate market which makes pricing more opaque.

An interesting aspect with the recent bout of spread widening has been the divergence with prior periods of rising yields. Typically, rising yields accompanied by an improving economic outlook has resulted in corporate spread contraction with outperformance of shorter-term, lower-rated, higher-beta issues. So far in this cycle, riskier issues have underperformed, highlighting the extent for which demand/supply imbalances created by QE have distorted risk-adjusted valuations and perhaps also suggesting lingering doubts over the Fed's macro forecast.

Despite the cautious market tone, Canadian investment grade new issuance during Q2 was robust at $20.5 billion. June saw a healthy $6.7 billion priced, which compared favourably with the $4.9 issued during June of last year and was remarkable considering global corporate bond sales for the month were the least since December 2011.

For the quarter, short, mid and long-term corporate yield spreads widened by 8, 8 and 1 basis points respectively, resulting in absolute returns of -0.67%, -2.69% and -4.13% respectively according to the DEX Corporate Bond Index. The long end of the credit curve outperformed as the backup in underlying government yields provided an opportunity for pension and insurance managers to pick up cheaper issues. On an absolute basis, spread tightening did little to mitigate the adverse effects of rising government yields in the long end.

Across the yield curve the best spread and absolute performance was reserved for pipelines, utilities energy generation and insurance.  Alternatively, telecom, media and senior bank debt underperformed.  Relative performance on a rating basis reflected the sector moves as single A rated debt outperformed across the curve.

## Portfolio Activity

Positions in Molson Coors 5.0/15 and Quebec 3.0/23 were sold and positions in Telus 5.0/19, Bell Canada 4.95/21 and Quebec 4.25/43 were increased or established. Tactically the moves provided relative sector value, and reduced the relative underweight in the long-end of the yield curve.

## What Worked In The Quarter

The portfolio's sector exposures had a more conservative, defensive bias relative to the index. Risk aversion resulted in these sectors to outperform.

## What Didn't Work In The Quarter

The portfolio was structured with an overweight in the belly (5-10 year) of the yield curve in lieu of long bonds. The 10–30 curve flattened by 22 basis points over the quarter.

Supply pressures and news that Verizon may enter the domestic wireless market weighed on telecom/cable spreads. The portfolio was overweight the sector however the holdings are relatively short in term (5-8 years) and provide attractive yield pick-up

## Outlook

We have not been surprised by the recent weakness in credit markets as we have felt that the demand/supply imbalance imparted by QE has overwhelmed valuations to a level where investors were becoming complacent on a risk/reward basis in their reach for yield.

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 arise.

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