LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Despite a material backup in yields and significant issuance in May, the domestic corporate market was steadfast with corporate spreads tightening by an average of 6 basis points. The pace of tightening was in sharp contrast to what was seen south of the border where corporates spreads were flat to wider for the month. The demand driven rally (domestic fixed income-oriented and balanced funds continue to see large inflows) and a continued concern over equity valuations, has kept yield hungry domestic investors looking to corporates as an alluring source of alpha.

May issuance at $10.2 billion, which was aided by large coupon flows and attractive spread concessions, and dominated by higher rated (A or higher) issuers, was a record for the month. Banks drove issuance with jumbo deposit note deals from CIBC ($1.25 billion 3- year), BNS ($1.3 billion 3-year) and BMO ($1.5 billion 7- year). Other notable issues included private placements from OMERS Realty ($1.1 billion across 2 tranches) and BHP Billiton ($750 million 10-year), with the latter being the inaugural maple bond (Canadian dollar denominated bond from a foreign domiciled issuer) of an investment grade miner.

An environment of high asset prices, fading risk aversion and low funding costs has added scope for event risk. Nowhere was this more apparent than the announcement by Tim Horton's management of unlocking asset value though a debt-funded share repurchase program which may result in a drop of its rating by a few notches. Elsewhere, Canadian Tire followed the lead of Loblaw and announced a REIT spin-off that will remove real estate assets worth $3.5bn from its balance sheet. In both cases, management stated an unconditional objective of maintaining an investment-grade rating post transaction. This appeared to appease bondholder concerns as the spread impacts were limited.

For the month, short, mid and long-term corporate yield spreads tightened by 3, 6 and 8 basis points respectively, resulting in absolute returns of -0.39%, -1.51% and -2.00% 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 asset and liability 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 higher beta sectors: energy generation and subordinated financials in the short and middle part of the curve, retail and telecom in the long end. Insurance also performed uniformly well across the curve as a sustained backup in rates would ease pressure on discount rates. Relative performance on a rating basis reflected the sector moves as lower rated BBB debt generally outperformed across the credit curve.

Outlook

We feel that investors are relatively complacent on a risk/reward basis in their reach for yield and that a certain level of caution is still warranted. While we do not expect any significant degradation in the general quality of domestic credit as corporate fundamentals which in terms of leverage, liquidity and profitability remain sound, we do feel that at current levels investors would not be adequately protected should macro data sour. Alternatively, we also 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.

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