LORICA | INVESTMENT COUNSEL INC.

# Focused Corporate Bond

## Market Highlights

Corporate bonds rallied globally in November as monetary policy was supportive for risk assets more generally and Fed comments continued to leave sufficient doubt that tapering of QE would be imminent. The Canadian corporate market was further buoyed by the embedded demand stemming from the December 1st coupon payments and maturities, and resulting index extension. Consequently, domestic investment grade yield spreads tightened by 2 basis points in November.

Receptive corporate buyers enticed opportunistic issuers resulting in $12.1 billion of investment grade new issues, a monthly record. The figure is that much more impressive, given that November coincides with the Canadian banks' self-imposed earnings black out period which resulted in only two domestic bank deals coming to market for a total of $2.25 billion. In lieu of bank issuance, volume was led by two Maple issuers - AT&T ($1 billion 7-year), BP Capital Markets ($450 million 7-year), Canadian auto finance subsidiaries (4 deals totaling $1.8 billion) and Wells Fargo Canada ($1 billion 5-year). Other notable issuance emerged from credit card receivables backed securities ($1.25 billion), Telus ($800 million), Thomson Reuters ($500 million) and Tim Hortons ($450 million) – with the latter two deals used to finance share repurchases through increased leverage.

Credit rating activity was notable over the month with broad moves made by S&P and Moody's. Moody's lowered ratings on a number of U.S bank holding companies based on their view that there would be more limited government support going forward. The well-telegraphed rating action (issuers have been under review since June) saw a relief rally in spreads post announcement. Later in the month, S&P revised its corporate rating methodology, resulting in positive credit watches for Gaz Metro, CN Rail and BMW and negative credit watches for EnerCare and AltaGas. Market reaction was most pronounced on AltaGas yield spreads, which widened on the possibility of being downgraded below its current BBB rating.

For the month, absolute returns were 0.28%, 0.03%, and -0.68% for short, mid, and long-term corporates according to the DEX Corporate Bond Index. Although short, mid, and long yield spreads tightened by 0, 2, and 4 basis points, the steepening of the government yield curve offset the corporate spread performance, particularly in the long-end. However, on a spread-basis, the long-end of the credit curve outperformed due to the grinding bid from asset/ liability managers who were picking-up cheaper issues on the backup in underlying government yields.

Across the yield curve the best spread and absolute performance was reserved for higher beta sectors: energy generation and real estate in the short-end of the yield curve, and retail in the mid and long ends. Insurance also performed uniformly well across the curve with favorable rate and equity movements. Alternatively, securitization, utilities, and telecom underperformed as a result of supply pressures. Relative performance on a rating basis reflected the investor posture toward risk, as lower-rated BBB debt modestly outperformed across the credit curve.

## Outlook & Strategy

Investors continue to be predisposed to the yield carry trade however with the prospect of tapering on the horizon we feel that investors are increasingly 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. From the perspective of corporate fundamentals, we feel that we have surpassed the credit cycle peak; however in the short-term we do not expect any significant degradation in the general quality of credit as corporate fundamentals which in terms of leverage, liquidity, and profitability still remain sound.

That being said, the portfolio is structured defensively and has minimal exposure to sectors or issuers that would 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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