LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Indications from both the Fed and the Bank of Canada that higher rates are still some ways off led investors to fully embrace the yield carry trade, resulting in corporate spreads to tighten by 5 basis points on average for the month. The move can be most aptly described as aggressive as investors extended both out the credit curve and the credit spectrum amongst a backdrop of relatively stagnant fund flows.

Receptive buyers for product enticed opportunistic issuance and resulted in a healthy $6.3 B of investment grade supply for the month. Banks led issuance with jumbo deposit note deals from RBC ($1.25 B 5-year), BMO ($1.25 B 7½ -year) and smaller deals from Laurentian Bank ($275 M) and Manulife Bank of Canada ($250 M). Other notable issuance emerged through inaugural issues from low-rated Dollarama ($400 M) and Crombie REIT ($175 M) – both 5-year private placements. Interest in REIT's was also found in the floating rate note space, where five issues (ranging from $60-$250 M) came to market via reverse inquiry. The illiquid floating rate issues (1-3 buyers per issue) were the first of their kind to be issued in Canada for the sector.

To date, Q3 earnings have been healthy and fundamentally supportive of credit with the notable exception of SNC Lavalin and Caterpillar whom had earnings/forecasts much lower than expectations and Thomson Reuters, who's positive Q3 results were overshadowed by the company's decision to modestly increase the leverage ratio target.

Outside of earnings, other significant Canadian credit events included the positive announcements for AltaLink L.P. (SNC-Lavalin beginning the process to sell an equity stake) and Brookfield Office Properties (acquisition by Brookfield Property Partners L.P.). Alternatively, the surprising Industry Canada rejection of Accelero's bid for Allstream placed Manitoba Telecom spreads under pressure.

For the month, short, mid and long-term corporate yield spreads tightened by 4, 6 and 5 basis points respectively, resulting in absolute returns of 0.75%, 1.53% and 1.99% respectively according to the DEX Corporate Bond Index. The middle part of the curve outperformed as it has the highest proportion of higher beta, lower rated issues.

Across the yield curve the best spread and absolute performance was reserved for telecom/cable - continued relief rally on a lack of foreign participation in the upcoming 700 MHz spectrum auction and retail - less on-going event risk. Alternatively, real estate -supply overhang and credit metrics negatively impacted by higher rates and defensive sectors (i.e. infrastructure, pipelines and utilities) under-performed. Relative performance on a rating basis reflected the investor posture toward risk as lower rated BBB debt generally 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 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 present themselves.

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