LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Geopolitical turmoil and mixed macroeconomic data caused the demand-driven rally in the corporate debt market to lose steam in April, resulting in flat domestic corporate spreads for the month. First quarter earnings reports, which aside from concerns over future margin growth and event risk associated with M&A and shareholder friendly initiatives, continue to support credit quality. With no clear consensus on where corporate rates are heading in the short-term, the complacency trade: *holding higher yielding corporates in a reach for yield* continues to be in vogue.

Despite the cautious tone in credit markets, primary issuance was still healthy at $4.4 billion, although there was also a notable lack of benchmark-sized (>$500 million) deals. From a supply perspective, we expect smaller deal-sizes to be an ongoing theme as first-time and infrequent issuers (whom have smaller funding needs) are drawn to the primary market to lock in historically low all-in yields. Of the notable new issues that did materialize: Telus ($1 billion two tranche deal), Genesis Trust ($1 billion real estate secured line of credit backed notes) and Pembina Pipelines ($600 million) were well received but most came without concessions and did not perform particularly well in the secondary market.

For the month, short and mid-term corporate yield spreads were flat whereas long-term spreads widened by 1 basis point, generating absolute returns of 0.31%, 0.64% and 0.90% respectively according to the FTSE TMX Corporate Bond Index. Whether due to rate concerns or a shift in credit risk/reward sentiment there was a noticeably increased aversion to long credit in April (outside of asset liability managers and indexers). Demand instead shifted to shorter duration (2-5 year) corporates as the yield carry trade became more defensive in nature. On an absolute basis, overall returns were predominately driven by the modest drop in yields across the underlying government yield curve.

The best spread and absolute performance across the yield curve was reserved for lower-rated higher-yielding smaller-sized issues in the energy and real estate sectors. Subordinated bank/insurance and holdco issues also performed well across the curve due to the higher yield that structurally subordinate debt provides. Under-performing issues were more defensive in nature such as higher-rated infrastructure and regulated utility names. Relative performance on a ratings basis reflected sector moves as BBB credit outperformed in the short and mid-term areas of the credit curve and A/AA (predominately financials) outperformed in the long-end.

Outlook & Strategy

Investors continue to be predisposed to the yield carry trade. We feel that the insatiable demand for credit may still have some legs and as a result investors have increasingly become complacent on a risk/reward basis in their reach for yield.

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. We do feel that a more upbeat economic outlook has the potential to mitigate further corporate spread tightening by provoking a significant deviation from conservative corporate policies.

The portfolio is structured conservatively and has minimal exposure to sectors or issuers that would be negatively impacted in the event of higher interest rates. We are well positioned to capitalize on relative value and yield enhancement opportunities.

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