August 31, 2014

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Corporate spreads came under pressure in August due to seasonally illiquid markets, expectations of a robust September supply calendar, and most significantly, risk aversion stemming from ongoing geopolitical tensions that continue to overshadow improving North American macroeconomic data. Overall, corporate spreads drifted wider over the month by 3 basis points on average. However, strains were more evident in bid-ask levels, particularly for higher beta issues, which widened materially.

Amidst an environment of investor apathy, the primary market stalled. For the month, an anemic $830 million of fixed rate corporate deals came to market, which was well off the monthly average of $6.7 billion, recorded until the end of July. A drop in issuance was similarly seen south of the border as U.S. investment grade and high yield deal volume fell by 54% and 89% from this year's monthly average, respectively. Domestically, new issuance consisted of three deals from Enbridge Gas ($430 million 2 tranche, 10 and 30-year), AltaGas ($300 million 30-year) and RioCan REIT ($100 million 8-year). Recent SEDAR filings, roadshow announcements, and a sizeable $3.8 billion in corporate maturities over September, suggest primary activity should pick-up considerably.

Burger King Corp. officially announced the proposed acquisition of Tim Horton's, which is expected to close in late 2014/early 2015. While much debate surrounded the strategic and financial motivations behind the deal, given the potential acquisition by a non-investment grade entity, Tim Horton's bondholders were understandably concerned. Allaying these concerns however was the fact that the three outstanding Tim Horton's bonds all contain a call provision ($101 put price) that is triggered in the event of a change of control and a downgrade to non-investment grade. With the call provision likely to be triggered, these issues are now trading near the $101 put price - a small premium above the pre-announcement level for the issue maturing in 2019.

For the month, short, mid and long-term corporate yield spreads widened by 2, 2 and 3 basis points respectively, resulting in absolute returns of 0.25%, 0.90% and 1.86% respectively, according to the FTSE TMX Canada All Corporate Bond Index. The parallel movement of the credit curve reflected the general cautious market tone. On an absolute basis, overall returns were predominately driven by the bull flattening of the underlying government yield curve – longer term yields fell by more than shorter-term yields.

The directionless, cautious tone in the corporate market was reflected in sector performance as bank debt (supported by the release of a bail-in debt consultation paper) marginally outperformed across the curve, whereas lower-rated issues in energy and retail generally underperformed. Relative performance on a ratings basis reflected the indecisive sector moves, as performance between rating classes was similar in the short-term area of the credit curve, AA-rated, predominately bank debt, led in the mid-term area, and A-rated credit outperformed in the long-end.

Outlook & Strategy

Investors continue to be predisposed to the yield carry trade and 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 are however concerned that in a scenario of rising rates and a rotation out of corporate bonds, corporate spreads – which have benefitted greatly from a demand/supply imbalance – may widen materially, as capital constrained dealers have reduced capacity to absorb bonds.

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

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com