February 28, 2014

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

In the face of emerging market jitters, the domestic corporate market remained resilient with corporate spreads tightening by an average of 4 basis points during February. The demand driven rally and concerns over equity valuations have kept yield hungry domestic investors focused on corporates as an alluring source of alpha. Aside from concerns over future margins and increased rhetoric on shareholder friendly initiatives, recent earnings and guidance have been innocuous from a credit perspective. Significantly, instances of earning misses, lowered guidance and aggressive dividend increases or share buybacks did not result in material changes to issuer credit spreads.

Robust demand and favorable market tone resulted in primary issuance of $7 billion, which was a marked improvement from the $2.5 billion issued during the same period last year. Notable issuance emerged from domestic banks ($2.5 billion), foreign financials ($1.3 billion), REIT's ($700 million) and West Edmonton Mall private placement ($900 million). Aided by light bank issuance and speculation over bail-in debt proposals (see below), the deposit note issues from Bank of Montreal (5-year) and Royal Bank (7-year) came at the tightest spread levels seen since before the credit crisis. Given strong investor appetite and the anticipation of higher rates, we foresee issuance to remain buoyant as issuers look for opportunities to term out bank debt, pre-fund upcoming maturities or refinance callable bonds.

Expectations that the Department of Finance would release the bail-in capital framework for domestic systemically important banks (D-SIB) prior to the Federal budget proved to be too optimistic, as no white paper materialized. Speculation has been rife that under the proposed framework, existing deposit notes will be either grandfathered from becoming bail-in debt either outright or through a delayed implementation date. A widely distributed research note highlighted that if existing deposit notes were to be grandfathered from participation in bank recapitalizations on a going concern basis and assuming the risk of default of a D-SIB is near zero, would imply, by extension (moral hazards aside), near zero default risk for existing deposit notes. Follow through buying led to a deposit note rally which also pulled instruments lower on the capital structure (i.e. sub debt, hybrids) along for the ride.

For the month, short, mid and long-term corporate yield spreads tightened by 4, 5 and 4 basis points respectively, resulting in absolute returns of 0.28%, 0.62% and 0.57% respectively according to the FTSE TMX Canadian Corporate Bond Index. Across the yield curve, the best spread and absolute performance was reserved for domestic bank debt (bail-in speculation) and lower rated, higher yielding sectors such as retail. Alternatively, telecom (due to costly 700MHz spectrum auction results) and more defensive, higher rated issues in utilities and pipelines underperformed. Relative performance on a ratings-basis reflected sector moves as AA rated credit (predominately senior bank debt) outperformed across the credit curve.

Outlook & Strategy

Investors continue to be predisposed to the yield carry trade. However with market dynamics tilting back towards normalcy, after a period of insatiable demand for credit, from both traditional and non-traditional investors, 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.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

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