January 31, 2014

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

In the first weeks of January, positive market sentiment, which coincided with the annual “start-of-year” increase in investor risk appetite, boosted credit markets. By month-end, however, emerging market jitters and a general move towards “risk-off” sentiment evaporated much of these gains. For the month, domestic investment grade yield spreads tightened by 3 basis points on average. Coupled with the flight-to-quality rally in underlying government yields, monthly absolute returns were the highest seen since the credit crisis.

New issue activity of $6.6 billion – down significantly from last January’s $9.4 billion – reflected deteriorating market sentiment. That being said, the deals that did materialize were heavily oversubscribed and generally, with a few notable exceptions, performed well in the secondary market. Issuance was dominated by the banks (four senior deals totaling $3.8 billion) and real estate (five deals totaling $625 million). The real estate deals were particularly noteworthy, as these unsecured issues came at attractive levels relative to where secured debt could be placed with banks.

With more than a year elapsing since the last bank subordinated (Tier 2) debt issue, which were phased out under Basel III, further steps were taken in January towards the development of a Canadian non-viability contingent capital (NVCC) Tier 2 bond market. First, the Office of the Superintendent of Financial Institutions indicated that it will replace the assets-to-capital (ACM) requirement with the Basel III leverage test in 2015. Unlike ACM, which includes total capital (Tier 1 and Tier 2), the Basel leverage measures excludes Tier 2, therefore reducing the need for Tier 2 capital. Second, RBC and National Bank issued the first Canadian Basel III-compliant NVCC perpetual preferred shares. While the retail-focused issues may have not provided much colour on potential institutional oriented subordinated debt pricing, they did prove to be instructive from a structural perspective. The next major milestone will come in February, when a senior debt bail-in regime (rules surrounding bank liabilities in the event of inadequate capital) consultation paper is set to be released before the 2014 federal budget.

For the month, short-, mid-, and long-term corporate yield spreads tightened by 3, 4, and 2 basis points respectively, resulting in absolute returns of 0.92%, 2.97%, and 5.01% respectively according to the FTSE TMX Canadian Corporate Bond Index. Across the yield curve, the best spread and absolute performance was reserved for the lower rated, higher beta sectors of telecom and media (reduced issuance expectations), retail (reduced supply overhang), and real estate (grab for yield). Comparatively, more defensive, higher-rated utilities, pipelines, and senior bank issues underperformed. Relative performance on a ratings basis reflected investors' persistent preference for 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 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, we expect the sector impacts of higher rates to 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 passed the credit cycle peak. However, in the short-term we do not expect significant degradation in the general quality of credit as corporate fundamentals, in terms of leverage, liquidity, and profitability, still remain sound.

The portfolio is structured defensively and has minimal exposure to sectors or issuers that would likely be negatively impacted by higher interest rates. Therefore, the portfolio is well positioned to capitalize on relative value and yield enhancement.

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