LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

The domestic corporate debt market adopted a cautious tone in July as escalating geopolitical risks overshadowed generally improving macroeconomic data. In sympathy with the general pullback in risk, corporate spreads drifted wider by one basis point for the month. However, strains were more evident in liquidity and bid-ask spreads, which materially deteriorated as the month progressed. In particular, high-yield bonds experienced a significant liquidity-driven sell-off as capital constrained banks and a lack of alternate buyers were unable to easily absorb outflows from high-yield mutual funds and exchange traded-funds.

The primary (new-issue) market reflected the general level of market trepidation, as a substantial portion of the $6.1 billion of corporate issuance was higher-beta, lower-rated opportunistic issues (WestJet, Reliance LP, Morgan Stanley), which underperformed in secondary markets. The balance of the month's issuance emanated from the domestic banks (three deals totaling $3.2 billion).

Of the bank issues, most notable was the inaugural $1 billion Basel III compliant non-viability contingent capital subordinated debt issue from RBC. Unlike existing subordinated debt, this new instrument, upon the occurrence of a trigger event (as set out by OSFI's capital adequacy requirements) will be converted into common shares as a means to recapitalize the bank. As the market was still waiting for the Department of Finance to release the "bail-in" capital framework for domestic systemically important banks (D-SIB) in order to properly evaluate the relative value of these new junior securities, many market participants were surprised by the timing of this deal. Nevertheless, the issue saw good demand and now that the structure has been endorsed by the market, other banks may quickly follow suit with similar issues.

For the month, short, mid and long-term corporate yield spreads widened by 2, 2 and 1 basis points respectively, resulting in absolute returns of 0.18%, 0.45% and 1.34% respectively, according to the FTSE TMX Canada All Corporate Bond Index. The parallel movement of the credit curve credit reflected the general cautious market tone. On an absolute basis, overall returns were predominately driven by the bull flattening (longer term yields fell by more than shorter-term yields) of the underlying government yield curve.

The cautious tone in the corporate market was also reflected in sector performance as lower-rated, higher-yielding issues in the auto finance, retail and energy sectors outperformed in the short and mid-term area of the credit curve, whereas more defensive, higher-rated issues in utilities and pipelines outperformed in the long-end. Relative performance on a rating basis reflected sector moves as BBB credit outperformed in the short and mid-term area of the credit curve and A-rated credit outperformed in the long-end.

Outlook & Strategy

Investors continue to be predisposed to the "yield carry" trade and have become more 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.

That said, the portfolio is structured conservatively and additionally has minimal exposure to sectors or issuers that would be negatively impacted in the event of higher interest rates. Therefore, we are well positioned to capitalize on relative value and yield enhancement.

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