LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

With low underlying government yields and a lack of market consensus on where credit spreads are heading in the short-term, the complacency trade of holding higher yielding corporates as a source of alpha remained popular during the quarter. This complacency however, can be most aptly described as subdued given that the bias favoured modestly extending out the credit curve with a focus on yield pickup, rather than a migration into lower credits. Overall, credit spreads tightened on average by one basis point during Q2, with the credit curve flattening.

Robust demand for corporates and supportive market tone resulted in healthy primary issuance of $19.3 billion during the quarter, which was marginally down from the $20.5 billion issued in the same period last year. Notably, domestic bank issuance of $16 billion (including FRN's) year to date was down from the $26 billion issued over the same period last year, as bank results for the quarter, which were relatively innocuous from a credit perspective, revealed materially slower consumer loan growth, and funding remained attractive internationally, particularly for shorter-dated notes. The supply vacuum created by less bank issuance was largely filled by smaller non-financial issues ($>500M) from first time and infrequent issuers whom have smaller funding needs and have been drawn to the primary market to lock in historically low all-in yields.

For the quarter, short-term corporate spreads widened by 3 bps whereas mid and long-term corporate spreads tightened by 4, and 1 bps respectively, resulting in absolute returns of 0.82%, 2.28% and 3.68% respectively, according to the FTSE TMX Canada All Corporate Bond Index. Spread compression was greatest in the mid-part of the credit curve as a result of its high concentration of BBB issues (representing roughly half of all mid-term corporates) and investors modestly adding duration risk to increase yield pick-up. On an absolute basis, overall returns were predominately driven by the flattening of the underlying government yield curve.

Across the yield curve the best spread and absolute performance was a mixed bag as the yield carry trade became more defensive in nature. Generally, out-performing credits were bank deposit notes, subordinated bank/insurance issues and holdco debt. Alternatively, more defensive, higher rated issues in infrastructure and regulated utilities underperformed in the short-end, while lower rated issues in retail and media lagged in the long-end. Relative performance on a ratings basis reflected the more cautious investor tone, as lower rated BBB debt outperformed in the short and mid areas of the yield curve, while A-rated debt modestly outperformed in the long-end.

Portfolio Activity

The portfolio was optimally structured on a yield curve and sector basis relative to our interest rate and sector forecasts, therefore trading was limited to the reinvestment of coupons into existing positions.

What Worked In The Quarter

The portfolio was overweight Quebec-centric names (National Bank, Capital Desjardins, Laurentian Bank etc.) which saw spreads rally to multi-year lows relative to their peers on the back of the solid PLQ mandate and the prospect of greater political stability going forward. The portfolio also had an overweight exposure in subordinated bank debt, and telecom and energy issues which were among the top performing sectors during the quarter.

What Didn't Work In The Quarter

Relative to the index, the portfolio was more conservatively structured with a shorter overall duration, an overweight in mid-term bonds and underweight in long-term bonds.

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.

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. 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