LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Elevated geopolitical risk, talk of ECB easing action and macroeconomic data that did not meet expectations, resulted in a bull flattening of the government yield curve during May. With the drop in rates, upcoming index extension (increased modified duration) and no clear consensus on where credit spreads are heading in the short-term, the complacency trade –holding higher yielding corporates as a source of alpha - remained popular. The stance however can be most aptly described as cautious as the spread tightening (1 basis point on average for the month) stemmed from a modest extension out the credit curve, with a focus on yield pickup, versus a migration along the credit spectrum.

Buoyed by large coupon flows and the June 1st index extension, $6.5 billion in investment grade credit was placed in May. The month's tally represented a healthy uptick from April but a significant decline from the record $10.2 billion issued in May of last year. Significant issuance came from HSBC Bank Canada ($1 billion), Canadian Natural Resources (two tranches totaling $1 billion) and Choice Properties (four tranches totaling $1 billion). Elsewhere, issuance was a hodgepodge of non-financial issuers, many of which took the opportunity to term out shorter dated debt/drawn credit facilities at attractive low all-in yields.

Domestic banks were largely absent from the primary markets due to their self-imposed issuance blackout prior to the release of Q2 earnings. That being said, the outlook for a deluge of deposit note supply appears increasingly unlikely as obtaining funding internationally remains attractive (particularly for shorter-dated notes) and Q2 bank results (which were relatively innocuous from a credit perspective) revealed materially slower consumer loan growth. Given the lack of new deposit note supply and the market belief that pending bail-in legislation will grandfather the seniority of existing deposit notes, there is little sector specific catalysts for deposit notes to materially underperform.

For the month, short, mid and long-term corporate yield spreads tightened by 0, 2 and 1 basis points respectively, which together with the decline in government yields, resulted in absolute returns of 0.41%, 1.26% and 2.29% respectively according to the FTSE TMX Canada All Corporate Bond Index. The middle area of the credit curve outperformed as investors modestly added duration risk to increase yield pick-up. The long end of the credit curve also continued to perform well as indexers were forced buyers of longer product in order to keep pace with the index extension. 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 cautious tone in the corporate market was reflected in sector performance as lower-rated, higher-yielding issues in the energy sector outperformed in the short and mid-term area of the credit curve whereas more defensive, higher-rated issues in infrastructure 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/AA (predominately infrastructure and financials) outperformed in the long-end.

Outlook & Strategy

Investors continue to be predisposed to the yield carry trade. We feel that the insatiable demand for credit may still have some legs and as a result investors will continue to be 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 do feel that a more upbeat economic outlook has the potential to mitigate further corporate spread tightening through a rotation into equities or a significant deviation from conservative corporate policies.

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.

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