November 30, 2014

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

The domestic corporate market adopted a cautious stance in November as spreads widened by an average of 1 basis point for the month. The guarded tone persisted through the month despite an uptick in equities, a drop in volatility and the embedded demand stemming from December 1st coupon payments and the resulting index extension.

The adverse impact of higher issuance that typically occurs in November was tempered this year as issuance totaled only $6 billion. While still a healthy sum, issuance was far off from the $12.1 billion issued in November of last year and is dwarfed by the $24 billion in coupons and index rollouts expected in early December. The gap can largely be attributed to a drop in domestic bank issuance – a function of slower consumer loan growth, funding remaining attractive internationally (particularly for shorted dated notes) and the latter part of the month coinciding with a self-imposed earnings black out period. Notable deals emerged from Saputo (inaugural $300 million 5-year), Metro Inc., which returned to the primary market after a hiatus of nine years ($600 million dual tranche 10 and 30-year) and a heavily oversubscribed issue from Suncor Energy ($750 million 7-year).

Legacy bank debt capital securities (subordinated debt, Tier 1 and Tier 2A hybrids) came under pressure, as uncertainty grew that the Department of Finance may not grandfather the loss absorption terms of these instruments when it releases its final bail-in capital framework for domestic systemically important banks. The concern is that through amendments to the CDIC Act, these legacy securities may be treated similarly to Basel III compliant non-viability contingent capital (NVCC) instruments and upon the occurrence of a trigger event (as set out by OSFI's capital adequacy requirements) may be converted into common shares as a means to recapitalize the bank. Somewhat allaying concerns however, is the fact that the implementation of the bail-in regime will likely not occur until late next year and that legacy issues primarily have shorter (5 years or less) first call dates upon which they begin to lose capital treatment.

For the month, short, mid and long-term corporate yield spreads widened by 0, 1, and 1 basis points respectively. This resulted in absolute returns of 0.53%, 1.42% and 2.56% respectively according to the FTSE TMX Canada All Corporate Bond Index. The credit curve modestly steepened as longer duration needs were met with more conservative provincial bonds (long provincial spreads tightened by 4 basis points on average for the month). On an absolute basis, overall returns were largely driven by the bullish shift of the underlying government yield curve (yields fell on average 18 basis points).

The cautious tone in the corporate market was reflected in sector performance as lower-rated, higher-yielding issues in the telecom/cable sector marginally outperformed in the short-term area of the credit curve; whereas, more defensive, higher rated issues generally outperformed in the mid and long-term area of the yield curve. Notably, despite the recent oil rout, the spread widening on energy exploration and integrated producers – which constitute roughly 1.5% of the corporate index - was limited to an average of 6 and 3 basis points for mid and long-term issues respectively. The greater impact was evident in the Canadian high yield space (energy and oilfield services comprise 40 percent of the FTSE TMX High Yield Index) where a number of smaller producers that borrowed heavily to fund development came under significant pressure.

Outlook & Strategy

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 credit metrics. We do feel that an upbeat economic outlook has the potential to mitigate corporate returns through a deviation from conservative corporate policies and asset class rotation. Corporate spreads which have benefitted greatly from a demand/supply imbalance may widen significantly in periods of volatility as capital constrained dealers have reduced capacity to absorb trade flow.

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 are therefore, well positioned to capitalize on relative value and yield enhancement opportunities.

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