October 31, 2014

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Surging volatility and illiquidity pressured domestic corporate bonds through mid-October followed by some improvement in overall market tone into month-end; the net result was corporate spread widening of 6 basis points for the month. Illiquidity was evident in bid-ask levels (particularly for higher beta issues) which remained strained, a function of both the negative market tone and banks in capital preservation mode heading into fiscal year-end.

Amidst reduced risk appetite, primary market issuance of $4.1 billion was limited to higher rated issues in the bank and utility space. Jumbo 5-year deposit note deals emerged from BNS ($1.5 billion) and National Bank ($1 billion), while CIBC became the third domestic bank to issue Basel III compliant non-viability contingent capital (NVCC) subordinated debt with a $1 billion, 5 year deal. Despite these bank deals, domestic bank issuance (including FRN's) of $28 billion year- to-date is down significantly from the $40 billion issued over the same period last year due to slower consumer loan growth and the continuing attraction to international funding, particularly for shorted dated notes.

Adding to the recent trend of longer maturity (>30 years) issues, CU Inc. and Fortis Alberta each brought $200 million in long bonds to the market. This brought the weighted average term-to-maturity of issuance this year to 9 years, which is significantly more than the 7.2 years over the same period last year. Long bond issuance has been driven by a confluence of supply factors – issuers taking advantage of historically low all-in- yields and reduced shorter dated bank debt issuance; and demand factors – asset liability managers needs and indexers whom are forced buyers of longer product in order to keep pace with index extensions factors.

For the month, short, mid and long-term corporate yield spreads widened by 7, 6 and 6 basis points respectively, resulting in absolute returns of 0.25%, 0.44% and 0.63% respectively according to the FTSE TMX Canada All Corporate Bond Index. The parallel movement of the credit curve represented increased investor risk aversion. On an absolute basis, overall returns were positive due to yield pickup and a downward shift of the underlying government yield curve (yields fell on average 10 basis points).

The cautious tone in the corporate market translated into sector performance with lower-rated, higher-yielding issues in the telecom/cable sector marginally outperforming in the short-term area of the credit curve, and more defensive, higher rated issues outperforming in the mid and long-term area of the credit curve. Relative performance on a rating-basis echoed the sector moves as performance between rating classes was similar in the short-term area of the credit curve, and A/AA- rated credit outperformed in the mid and long-term.

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 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.

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