April 30, 2015

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Despite a material backup in underlying government yields, concerns over equity valuations have kept yield-hungry domestic investors focused on corporates as a source of alpha. As a result, domestic investment grade spreads tightened by 2 basis points, on average in April. The move can be most aptly described as cautious, as investors were hesitant to extend into longer duration, higher beta credit.

Issuance was biased to shorter-term maturities which accounted for 88% of the $4.3 billion of new issues that came to market in April. Notable issuance emerged from HSBC Bank Canada (deposit note), securitization vehicles – Genesis Trust II (TD real estate secured lines of credit) and Canadian Credit Card Trust II (National Bank credit card receivables), Canadian non-bank mortgage lenders – First National Financial, CHIP Mortgage Trust and MCAP Commercial L.P., and Hydro One. The Hydro One deal for $350 million – which came post the Ontario government's IPO announcement (further details below) – served as a litmus test on valuations for Hydro One debt in the secondary market. In terms of testing the market, the new issue was a success as the deal came with an immaterial new issue concession and was almost twice oversubscribed.

On the provincial front, following the recommendations of the Premier's Advisory Council on how to optimize the value of government assets, the Ontario government announced the proposed partial sale of equity in Hydro One. Significantly, the province's ownership stake would be reduced to 40% over the next 4-5 years (and prohibited by law from reducing ownership below this threshold), pro-provincial governance agreements would be put in place, and the mandate of the Ontario Energy Board would be strengthened. The loss of provincial ownership was negative from a rating perspective (S&P lowered the rating to A from A+ following the announcement), but market reaction was muted (long spreads widened 2-3 basis points) as the focus remains on the strength of the regulatory and governance framework.

On the federal front, the Budget provided few details on the implementation of a bail-in capital regime for domestic systemically important banks. While it did highlight that outstanding deposit notes will not be converted to a bail-in format and the adoption of a holding company structure will not be required to accommodate the new framework, the market still awaits important regime details such as loss absorbing requirements, implementation/phase-in dates, and grandfathering of legacy capital instruments. Much of this detail is expected in legislation to be tabled in upcoming months. However with a federal election on the horizon, there is a risk that passing of the legislation may be delayed into next year.

For the month, short, mid and long-term corporate yield spreads tightened by 1, 3 and 1 basis points respectively, resulting in absolute returns of -0.4%, -1.0% and -2.3% respectively, according to the FTSE TMX Canada All Corporate Bond Index. The flattening of the credit curve credit out to mid-term maturities reflected a cautious reach for yield (as a source of alpha), with waning demand for duration and long credit risk (particularly long beta issues), and weakness in utilities (electricity and gas distributors make up one-third of long corporates). On an absolute basis, overall returns were predominately driven by the shift higher of the underlying government yield curve. For the month, underlying 2, 5, 10 and 30 year government yields rose by 16, 21, 22 and 19 basis points respectively.

On a sector basis, the best spread and absolute performance across the yield curve was reserved for issuers that experienced moderate spread widening in March (1-3 basis points) on the back of supply. April saw these issues retrace their relative underperformance that resulted from the supply overhang. Alternatively, utilities modestly underperformed due to lingering regulatory concerns. On a rating basis, performance between rating classes was similar in the short-term area of the credit curve, but AA-rated credit modestly outperformed in the mid and long-term as the widening basis between AA-BBB was positively correlated with term.

Outlook & Strategy

From the perspective of corporate fundamentals, we feel that we have surpassed the credit cycle peak. Also, low energy prices remain a concern on both a macro and micro level. However, in the short-term, we do not expect any significant degradation in credit metrics; and in the medium-term, any direct and indirect adverse impact on investment grade credit will be mitigated by strong credit profiles and limited concentration and counterparty risk.

Corporate spread levels currently represent more than half of all-in-yields (high end of post-credit crisis range) and thus provide good relative value. The portfolio is structured conservatively, possesses good liquidity, and is, therefore, well positioned to capitalize on relative value and yield enhancement opportunities.

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