LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

The domestic corporate bond market adopted a risk-off stance in August as concerns grew over the health of the Chinese economy and its impact on the global economy, commodity prices, equity market sentiment, and, ultimately, US monetary policy. For the month, domestic corporate yield spreads widened by an average of 11 basis points, with investors eschewing issues further out the credit curve and the credit spectrum. Notably, domestic corporate spreads were unable to capitalize on the uptick in risk-on sentiment that lifted equity markets into month-end as technical factors such as liquidity, changes in index composition, and the increase in the passive investor base, continue to be a significant driver of corporate bond performance in the current volatile environment.

Amidst the erosion of investor risk tolerance, the primary market stalled. For the month, an anemic $700 million of fixed rate corporate deals came to market, which was well of the monthly average of $7.9 billion recorded until the end of July. New issuance consisted of a $450 million 4 year issue from Daimler Canada Finance, a $75 million reissue from Allied Property REIT, and a $181 million issue from Access Prairies Partnership. The latter two issues were thinly subscribed, and all new issues traded at wider spread levels relative to where they were priced, despite generous yield spread concessions upon being issued.

For the month, short, mid and long term corporate yield spreads widened by 10, 11 and 12 basis points respectively. This resulted in absolute returns of -0.30%, -0.69% and -2.61% respectively according to the FTSE TMX Canada All Corporate Bond Index. The parallel movement of the credit curve reflected heightened risk aversion. On an absolute basis, longer term corporate bonds underperformed due to the bear steepening (longer term yields rose by more than shorter term yields) of the underlying Government of Canada yield curve.

On a sector basis, the best spread and absolute performance across the yield curve was reserved for higher rated, lower risk issues in senior bank debt and infrastructure. The outperformance of senior bank debt was notable, as recent earnings calls, which focused on the quality and stress testing of the bank's oil and gas portfolios, appear to have allayed fears over a significant deterioration of credit quality should energy prices remain low.

At the opposite end of the performance spectrum, yield spreads for higher beta, lower rated issues in oil, real estate and pipelines underperformed due to deteriorating fundamentals, expected new issuance and portfolio reshuffling. Recent downgrades that resulted in material changes in the ratings bucket composition of the corporate index would have caused indexed and quasi-indexed portfolios to adjust credit exposure. Relative performance on a ratings basis reflected the sector moves as AA-rated credit outperformed across the credit curve with the movement of AA-BBB credit yield spreads increasing with term-to-maturity.

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 deterioration in credit metrics. We do feel that the prospect of higher rates has the potential to mitigate corporate returns through asset class rotation, reduced liquidity and aggressive issuance activity. In this environment we foresee investors continuing to be cautious by reducing exposure to higher beta credit out the credit curve.

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

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com