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LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

An improving macro backdrop in the US, more global QE, rising equity markets and low underlying government yields stoked interest in corporates, both in the US and domestically, in February. For the month, Canadian corporate yield spreads tightened by an average of 4 basis points with a preference for increased exposure to term risk versus credit risk.

With investors more receptive to new issuance compared to last month, issuers were franticly locking in historically low all-in borrowing costs. There was $8.4 billion worth of new issues in February – a record for the month. Issuance was dominated by three deposit note deals totaling $5 billion from Royal Bank ($2.25 billion 7-Year), Bank of Nova Scotia ($1.75 billion 3- year) and National Bank ($1 billion 5-Year). All deals were well oversubscribed given Q1 bank earnings which allayed concerns over the negative credit impact of lower energy prices and the pent-up demand stemming from a paucity of recent domestic bank issuance. Issuance had been limited due to slow consumer loan growth, attractive funding alternatives internationally (particularly for shorted dated notes) and uncertainty over the final bail-in capital framework terms for domestic systemically important banks.

With regards to the bail-in capital framework, after much debate, FTSE TMX Global Debt Capital Markets announced that after surveying investors it would not include Basel III compliant non-viability contingent capital (NVCC) instruments in the DEX index, bringing it in-line with most other global indices which do not include similar instruments. It would however include bail-in senior debt (when issued) and following its inclusion would reconsider NVCC eligibility in light of the market environment at the time. While the gradual phasing out of Tier 2 capital securities (representing 4% of the corporate index) from index inclusion is significant, the exclusion of senior debt was of greater concern as it represents 23% of the corporate index.

For the month, short, mid and long-term corporate yield spreads tightened by 1, 6 and 6 basis points respectively, resulting in absolute returns of 0.09%, 0.20% and 0.11% respectively according to the FTSE TMX Canada All Corporate Bond Index. The flattening of the credit curve reflected investors reaching for yield by moving to longer maturities. 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 8, 4, 4 and 8 basis points respectively.

The cautious investor stance was evident in sector performance as lower-beta, higher rated issues in utilities, pipelines and senior bank debt generally outperformed across the curve. The outperformance became more pronounced as one moved out the credit curve as the widening yield basis between A-BBB was positively correlated with term. As a result, performance between rating classes was similar in the short-term area of the credit curve (i.e. higher yield of lower-rated offset relative spread underperformance), and A/AA- rated credit outperformed in the mid and long-term. A notable outlier of this trend however was the investment grade oil space which saw some rebound in spreads across the curve (on average 12 bps) following the dramatic widening of December and January, as oil prices stabilised.

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. The drop in energy prices remains a concern on both a macro and micro level, but we feel that, 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 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