January 31, 2015

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Ongoing risk aversion stemming from a mixed global macro backdrop, declining oil prices and deflation concerns, quelled the annual uptick in investor risk sentiment that the domestic corporate bond market typically experiences in January. For the month, corporate spreads widened by an average of 5 basis points with investors biased towards reduced exposure to higher beta credit out the credit curve and the credit spectrum. Liquidity remained strained with wide bid-ask levels (particularly for higher beta issues) and increased trading on an agency basis. Despite the spread widening, monthly absolute returns were the highest seen since 1997 (when the Corporate Index yield was 6% versus 2% today) as underlying government yields rallied on the back of an ECB quantitative easing program, Bank of Canada rate cut and a flight-to-quality.

For the month, short, mid and long-term corporate yield spreads widened by 4, 5 and 6 bps respectively, resulting in absolute returns of 1.94%, 4.15% and 6.60% 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, overall returns were predominately driven by the bull steepening of the underlying government yield curve. For the month, underlying 2, 5, 10 and 30 year government yields fell by 61, 72, 64 and 49 basis points respectively.

Risk aversion was evident in sector performance as more defensive, lower-beta, higher rated issues in utilities and infrastructure generally outperformed across the curve. The outperformance became more pronounced as one moved out the credit curve as the widening basis between A-BBB was increased with term. As a result, performance between rating classes was similar in the short-term area of the credit curve (higher yield of lower-rated issues offset spread widening), while non-financial A & AA rated credit outperformed in the mid and long-term.

Domestically, the rout in oil continued to dominate credit headlines. In the Canadian high yield space (where energy and oilfield services comprise 40 percent of the FTSE TMX High Yield Index) spreads gapped out by over a 100 basis points, on average. Distressed names were active: e.g. Southern Pacific sought creditor protection and Connacher proposed a recapitalization via a debt for equity exchange. Reduced investor risk tolerance was also evident in other non-energy high yield names, notably miners and Bombardier. In contrast, short, mid and long-term spreads in the Canadian investment grade oil space widened by 16, 14 and 9 bps respectively over the month. The relatively muted spread movement was a reflection of the low leverage, liquidity, capital spending flexibility and scarcity premium attached to these issuers.

Credit was also indirectly adversely impacted from lower oil prices via the surprise 25 basis point rate cut from the Bank of Canada. The move unnerved the market as it gave credence to a “weakening economy” view, thus putting pressure on spreads of higher-beta issuers and banks (declining margins).

Despite historically low all-in borrowing costs, January new issuance was a paltry $3.4 billion, the slowest pace of issuance for the month in 8 years. Significant issuance emerged from the banks (BNS and Laurentian 5-year deposit notes totaling $1.6 billion), Pembina Pipelines ($600 million two part tranche), and REITS (four deals totaling $600 million). The latter REIT deals were notable as they coincided with the announcement of Target’s exit from the Canadian market, which, while only accounting for a small fraction of revenues (no issuer exposure greater than 2%), when coupled with other recently announced retail closures (Jacob, Mexx, Smart Set) may be a headwind for commercial leasing rates going forward. Generally, new issues came to market with healthy concessions and were met with good demand. However, secondary spreads of outstanding issues (particularly for the lower-rated issuers) widened out to the clearing levels of the new deals.

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. However, 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. The negative economic outlook may spark reviews of corporate spending and borrowing plans, which could diminish issuance expectations for Canadian corporates.

Corporate spread levels currently represent more than half of all-in-yields (highest level post-credit crisis) 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