LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Mixed macroeconomic data, Chinese stock market jitters, falling commodity prices and ongoing constrained liquidity compelled corporate bond investors to adopt a risk-off stance in July. Additionally, Canadian credit was impacted by the 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. Bank spreads were notably affected by the flattening yield curve and its negative impact on margins.

For the month, Canadian corporate spreads shifted wider by an average of 7 basis points, with acute pressure experienced by issuers and sectors which tapped the primary market during the month. While investors continue to focus on corporates as a source of alpha, there is increased hesitation to extend into longer duration credit (except by long-term asset liability managers) and lower rated, higher beta issues in a market that is biased to leak wider and has limited depth.

With reduced liquidity, there remained a focus on new issuance in lieu of secondary markets. Generally, new issues came with material concessions, however most were met with modest demand and as a consequence of reduced liquidity, few tightened significantly in secondary trading. Of the $7.8 billion that came to market, significant issuance originated from the banks ($4 billion in deposit notes) and Project Finance ($2.2 billion). Project Finance issuance, consisting of mainly thinly held sporadically traded long-term issues, reached $5.3 billion year-to-date, more than doubling last year's issuance of $2.4 billion. These long deals also pushed the weighed term to maturity of debt issued for the month to 13 years, significantly higher than the 9 year weighted term for the corporate index.

For the month, short, mid and long-term corporate yield spreads widened by 7, 8 and 7 basis points respectively. This resulted in absolute returns of 0.30%, 1.14% and 1.90% respectively according to the FTSE TMX Canada All Corporate Bond Index. The parallel movement of the credit curve reflected heightened risk aversion and pressures associated with issuance – bank deposit notes in the short-end and public private partnership deals in the long-end. On an absolute basis, overall returns were predominately driven by the flattening of the underlying Canada curve. For the month, underlying 2, 5, 10 and 30 year government yields fell by 8, 19, 25 and 18 basis points respectively.

On a sector basis, the best spread and absolute performance was reserved for lower beta telecom issues (with no issuance overhang) in the short and middle parts of the yield curve and insurance, which modestly outperformed in the long-end. On the back of still falling commodity prices, energy underperformed in the short and mid-term area of the credit curve, whereas supply pressures resulted in infrastructure issuers to underperform in the long-end. Relative performance on a rating basis reflected the sector moves as higher-yielding BBB sectors that experienced no supply burden marginally outperformed across the credit curve.

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.

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