LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Volatile sovereign yields, reduced liquidity, a focus on new issuance in lieu of secondary markets and benign earnings guidance, compelled domestic corporate bond investors to be cautious bystanders in May. For the month, domestic corporate spreads traded in a relatively narrow range and moved marginally wider by an average of 1 basis point. While investors continue to focus on corporates as a source of alpha, there is increased hesitation (beyond long-term asset liability managers) to extend into longer duration credit with the prospect of higher underlying government yields on the horizon.

Unnerved by the rate volatility earlier in the month, primary issuance was relatively subdued at $7 billion versus the $8.8 billion placed on average for May over the last three years. Primary activity was heavily back-loaded to take advantage of the June 1st technical bid – a combination of large coupon payments and index extension. Sizeable issuance emerged from banks ($2.5 billion), real estate ($1.3 billion) and autos ($1 billion). The largest issue to come to market during the month - a $1 billion inaugural Wells Fargo 10 year subordinated debt deal – was notable as there has been no Maple subordinated debt deals since the credit crisis. The high yield space also saw its first issue of the year, with an inaugural $250 million dollar issue from Brookfield Residential Properties. Generally, new issues came with material concessions, but, as a consequence of reduced secondary liquidity, few tightened significantly in secondary trading.

Regionally, the election of the NDP government in Alberta (ending 44 years of Progressive Conservative rule) pressured spreads of Alberta-centric issuers. From a credit perspective, the NDP election platform had two notable pledges: 1. The pledge to phase out coal-fired electricity generation resulted in widening of the long term spreads of TransAlta and Capital Power by up to 10 basis points due to the long weighted average life of each firm's coal fleet. Other names in the power sector (AltaGas, CU Inc.) also saw some spread weakness as the potential loss of coal generation (approximately 40% of installed provincial capacity) increased uncertainty and event risk in the Alberta power market. 2. The NDP has promised a review of the current oil and gas royalty framework. While it remains to be seen what changes may be implemented, the NDP has been forthright that the current regime is unpalatable. Whereas the impact of any revisions should be limited to the investment grade energy space (issuers are integrated), high yield issuers may see further strains on already weakened credit profiles.

For the month, short and long-term corporate yield spreads widened by 2 basis points, whereas mid-term spreads were flat. Underlying 2 and 5-year government yields fell by 11 and 9 basis points whereas 10 and 30-year yields rose by 3 and 2 basis points respectively. Steepening of both the sovereign and credit curves resulted in absolute returns of 0.43%, 0.31% and -0.31% for the Short, Mid and Long FTSE TMX Canada All Corporate Bond Indices, respectively.

The modest widening in the short and long-term areas of the credit curve reflected some trading pressure associated with upcoming issuance – shorter-term financial and longer-term public-private partnership deals.

On a sector basis, the best spread and absolute performance, across the yield curve was reserved for energy (oil price stabilizing) and insurance issuers (outlook for Fairfax Financial revised to BBB- stable from negative by S&P). At the opposite end of the performance spectrum, yield spreads for infrastructure widened in anticipation of upcoming issuance. Relative performance, on a ratings basis, reflected the sector moves as higher- yielding, higher- beta BBB-rated credit modestly 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 degradation in credit metrics. Low energy prices remain 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.

Corporate spread levels currently represent nearly half of all-in-yields 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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