LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

During November, domestic corporate yield spreads ground tighter by an average of 2 basis points, amidst a backdrop of muted secondary trading activity, underwhelming primary issuance, and embedded demand stemming from the December 1st coupon payments and corresponding index extension. The conviction behind the move was fragile at best. The end of Q3 earnings season was, aside from some instances of weak guidance and increased rhetoric on shareholder friendly initiatives, innocuous from a credit perspective. Generally, the movement of domestic credit spreads continues to be largely driven by macro factors more than micro trends.

For the month, short, corporate yield spreads were flat whereas mid and long-term spreads tightened by 4 and 3 basis points respectively, resulting in absolute returns of 0.2%, 0.3% and 1.1% respectively according to the FTSE TMX Canada All Corporate Bond Index. The flattening of the credit curve reflected a dearth of mid and long bond issuance for the month which allowed corporate spreads in these terms to drift tighter. Absolute returns were reduced by the moderate bear flattening (greater rise of short-term yields) of the underlying government yield curve. For the month, underlying 2, 5, and 10 year government yields rose by 5, 3 and 2 basis points respectively, whereas 30 year yields fell by 2 basis points.

New issuance underwhelmed in November with $2.9 billion being priced, which was significantly less than the $6 billion and $12.1 billion issued in November of 2014 and 2013 respectively. Of the six deals that came to market, jumbo issuance emerged from Manulife (5-year subordinated Opco.) and HSBC (3-year deposit note). The dearth of issuance can largely be attributed to robust refinancing activity this fall, cautious credit markets, and opportunistic issuers delaying deals until the first half of December when large coupons flows increase the likelihood of a successful deal.

Late in the month, Alberta announced a phase-out of coal-fired generation by 2030 and an acceleration of renewable energy construction. Capital Power, whose relatively young coal plants now face early retirement, saw its credit spreads widen by 70 basis points on the back of the news. Domestic credits that also saw spread widening on the back of negative events included Canadian Pacific Railway (merger proposal for Norfolk Southern), Aimia (aggressive stock buyback) and Alliance Pipeline (DBRS downgrade). Alternatively, positive actions in the telco space resulted in the spread narrowing of BCE (equity issuance) and Manitoba Telecom (sale of Allstream).

Across the yield curve, the best spread and absolute performance was reserved for higher yielding issues (as a source of alpha) in telecom (BCE), legacy subordinated bank debt, and lower rated issues in retail and real estate. The worst performance came from generation (Capital Power, TransAlta), insurance (supply overhang), and transportation (geopolitical concerns and upcoming supply). Of note, the bifurcation between the investment grade and high yield oil and gas sector increased as investment grade credit spreads outperformed (tightening by 3 basis points on average), whereas high yield oil and gas credit spreads widened by an average of 110 basis points. Relative performance on a rating basis reflected the sector moves as higher-yielding BBB sectors that experienced no supply burden marginally outperformed across the 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. We do feel that in the near term corporate spreads will remain under pressure due to ongoing reduced liquidity and aggressive issuance activity. In this environment we foresee investors continuing to be cautious with exposure to higher beta credit out the credit curve.

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