LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

The domestic corporate market diverged from U.S. credit markets in October. Whereas U.S. corporate spreads tightened by an average of 12 basis points for the month, domestic credit spreads widened by 2 basis points. The divergence was a function of: ongoing constrained liquidity in the Canadian secondary market, amplified by dealers in capital preservation mode heading into fiscal year-end; robust primary supply anticipation, which never materialized in Canada; and doubts on the part of Canadian corporate bond investors that the recent strength in corporate markets has legs.

For the month, short, mid and long-term corporate yield spreads widened by 1, 3 and 3 basis points respectively, resulting in absolute returns of -0.02%, -0.43% and -1.30% respectively according to the FTSE TMX Canada All Corporate Bond Index. The modest steepening of the credit curve reflected a bias to reduce duration exposure to credit. Absolute returns were further negatively impacted by the steepening of the underlying Canada yield curve. For the month, 2, 5, 10 and 30 year Canadian yields rose by 5, 7, 10 and 9 basis points respectively.

To date, domestic Q3 earnings have been healthy and fundamentally supportive of credit with the notable exception of TransAlta which had below forecast earnings and weakening credit metrics. The poor results came on the heels of its settlement agreement with the Alberta Market Surveillance Administrator related to energy price manipulation; and Moody's placement of TransAlta's Baa3 rating – one notch away from non-investment grade – on review for downgrade. Moody's will consider management's actions to strengthen the balance sheet and bolster liquidity during its three month review to resolve the rating.

Outside of earnings, other significant credit events in Canada included: the Suncor offer for Canadian Oil Sands – neutral impact on spreads for the former, positive for the latter; progression on the AB InBev proposal to acquire SABMiller – pressuring the spreads of AB InBev and Molson Coors; and BMO's private placement of a high coupon $600 million rate reset preferred share (Tier 1) issue that significantly re-priced the spreads of non-viability contingent capital (Tier 2) debt wider.

Across the yield curve the best spread and absolute performance was reserved for: auto finance – strong auto sales and retracement of prior VW related spread widening; telecom and cable – solid earnings reports; and senior and legacy subordinated bank debt – reduced issuance and liquid corporate proxy. Alternatively, lower rated higher beta issues in power generation (TransAlta) and bank hybrid debt (issuance expectations and pricing concerns) underperformed. Notably, liquid longer-dated higher rated issues in financials, utilities and pipelines modestly underperformed as pension and asset liability managers sold positions to make room for project finance deals. On a rating basis, A and AA rated credit outperformed in the short and mid-term area of the credit curve, whereas BBB modestly outperformed in the long-end as a result of supply pressures. The widening spread between AA-BBB was negatively correlated with term.

Whereas U.S. investment grade corporate bond sales had a record October, primary activity in Canada was more muted. In total, $6.3 billion came to market with significant origination from the banks ($3.7 billion), credit card securitization ($800 million) and project finance ($673 million). Looking forward, despite a lack of large near-term maturities to spur refinancing activities and a number of issuers in self-imposed earnings blackouts, expectations are for a robust new issuance calendar In November as issuers take advantage of the embedded demand stemming from December 1st coupon payments and the resulting index extension.

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 capitalise on relative value and yield enhancement opportunities.

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