LORICA | INVESTMENT COUNSEL INC.

# Focused Corporate Bond

## Market Highlights

Amidst a backdrop of supportive monetary policy and rising commodity prices, the reach for yield was evident in risk assets globally. Domestic investment grade corporate bonds were further buoyed by sporadic primary issuance and late in the month, GE Capital Canada's announcement of a tender offer of $5.15 Billion worth of its (largely short-dated) outstanding debt. The resulting supply/demand disequilibrium resulted in a tightening of investment grade spreads by an average of 16 bps during the month. The move can be most aptly described as aggressive, as despite the backdrop of deteriorating corporate fundamentals, investors increased exposure to longer dated, lower rated credit.

Given the underlying demand for product, primary market issuance of $5 Billion was underwhelming and unable to satiate the demand. Issuers are continuing to take advantage of attractive funding levels in other markets such as international and direct bank financing; however opportunistic issuance did emerge from infrequent, less liquid issuers. Three bank deals (deposit notes, covered bonds) dominated issuance, totaling $3.8 Billion. Of note, Aviva PLC came to market with an inaugural subordinated Tier 3 debt issue, for $450 Million - the first of its kind in Canada.

Great-West Life became the first Canadian issuer to extend a fixed-floater in any jurisdiction as it opted to not exercise its first call option (final maturity is 2046) on a US subsidiary related bond. The unconventional extension decision, which widened the yield spreads of similar $C Great-West Life bonds by up to 700 bps, was based on economics (a savings of ~50bps). While US investors have been accustomed to this type of behavior – Bank of America and J.P. Morgan have in the past extended $C fixed floaters, many Canadian investors viewed the action as the break of a long-held gentlemen's agreement, between issuer and investor, that fixed/floaters would not be extended unless the issuer is under duress. Despite the surprise extension, contagion – given the reputational risks of extensions for issuers reliant on the fixed/floater market for funding to the rest of the fixed/floater space – appears negligible for now. It is worth noting that Great-West does not have any material upcoming Canadian maturities.

For the month, short, mid and long-term corporate yield spreads tightened by 14, 18 and 16 bps respectively. The bull flattening of the credit curve reflected a demand for longer maturities and a bias to increasing exposure to longer-term, higher beta credit. Absolute returns were dampened by rising underlying government yields - 2, 5, 10 and 30 year yields rose by 14, 19, 18, and 7 points respectively, resulting in absolute returns of 0.17%, 0.42% and 1.35% for short, mid and long-term corporates.

On a sector basis, the best spread and absolute performance was reserved for higher beta, lower rated issuers in energy exploration, energy generation and pipelines. Alternatively, higher rated issues in infrastructure and insurance sector (notably, GWL) underperformed. Relative performance on a ratings basis reflected sector moves, as lower rated debt outperformed across the credit curve.

## Outlook & Strategy

From the perspective of corporate fundamentals, we have surpassed the credit cycle peak. The continuing deterioration in credit metrics coupled with the growth of lower rated debt (BBB-rated debt now accounts for the largest portion of corporates) has made the domestic corporate market more sensitive to global event risk. We feel that in the near term there is increased risk that corporate spreads will come under pressure as they are currently buoyed by a demand/supply imbalance which may be fleeting. 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 of investment grade credit will be mitigated by strong credit profiles and limited concentration and counterparty risk.

In this environment we foresee investors being cautious with exposure to higher beta credit out the credit curve, particularly for those issues with limited secondary market depth. Corporate spread levels currently represent over sixty percent 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.

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