LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

With low underlying government yields, sanguine corporate earnings and the expansion of the Bank of England's QE program, the reach for yield was evident across risk assets globally, with domestic corporate bonds being of no exception. For the month, domestic corporate yield spreads ground tighter by an average of 3 bps, however there was a notable preference to take on term risk versus credit risk as long-term, higher beta bonds underperformed. Generally, the movement of domestic credit spreads continues to be largely driven more by macro and supply factors than micro trends.

For the month, short, mid and long-term corporate yield spreads tightened by 4, 3 and 3 bps respectively, resulting in absolute returns of 0.19%, 0.41% and 1.03%. The parallel shift of the credit curve reflected the focus on incremental yield pick-up rather than expectations of credit spread tightening. On an absolute basis, short-term corporate bond returns were tempered by the modest flattening of the underlying government yield curve. For the month, 2 and 5-year government yields rose by 4 bps whereas 10 and 30 year government yields fell by 1 bp.

On a sector basis, the best corporate returns in the short and mid-term were reserved for higher beta sectors and securities - energy exploration (oil consolidating recent price gains), pipelines and subordinated bank hybrid debt (both benefitting from reduced supply expectations). The tolerance for risk did not extend to the longer term area of the credit curve where defensive sectors – utilities and infrastructure - outperformed. Relative performance on a rating basis reflected the cautious reach for yield as BBB credit generally outperformed through the short and mid-term area of the credit curve, whereas A-rated credit led in the long-end.

Robust demand, slim new issue concessions and historically low rates brought out opportunistic issuers which led to an impressive $6.1 Billion in investment grade supply for the month – a record for August. Issuance was almost exclusively non-financials which took advantage of a dearth of supply from domestic banks which were in self-imposed issuance blackout prior to earnings releases. Notable deals emerged from Bell Canada ($1.5 Billion, two tranche deal), Canadian Natural Resources ($1 Billion) and Enbridge Pipelines ($800 Million, two tranche deal).

Outlook & Strategy

The continuing deterioration in credit metrics coupled with the growth of the BBB-rated debt class 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 stemming from a reach for yield and international flows which may be fleeting. Low energy prices remain a concern on both a macro and micro level, however we feel that 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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