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LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Volatile energy prices, eroding central bank credibility and headwinds from concessionary issuance pressured domestic corporate spreads in February. For the month, corporate spreads widened by an average of 9 basis points (11, 10 and 5 bps in short, mid and longs respectively), with increased aversion to issues with oil exposure or with near-term financing needs. Secondary market liquidity remained strained, with wide bid-ask levels (particularly for higher beta issues), increased trading on an agency basis, and a focus on new issuance in lieu of secondary markets (as secondary spreads widen in sympathy on the back of new deals).

For the month, short and mid-term corporate yields rose by 18 and 10 bps respectively, while long-term corporate yields fell by 1 bp, resulting in absolute returns of -0.28%, -0.25% and 0.39% respectively according to the FTSE TMX Canada All Corporate Bond Index. The bear flattening of the credit curve reflected the higher concentration of underperforming energy exploration, domestic bank hybrid debt and insurance in the short-end of the credit curve versus the mid and long-term area. Absolute returns in the mid and long-term area were bolstered by the rally in the underlying government yield curve. For the month, underlying 2 year yields rose by 9 bps and 5, 10 and 30 year yields fell by 1, 4 and 6 bps respectively.

On a sector basis, the best spread and absolute performance was reserved for lower beta, higher rated issues in utilities, telecom and senior bank debt – the latter aided by foreign buying. In contrast, oil and gas producers and bank hybrid Tier 1 debt (impacted by issuance pressures and concerns over Deutsche Bank's ability to meet contingent convertible debt obligations) underperformed. Relative performance on a ratings basis reflected sector moves as higher-rated debt outperformed across the curve however the outperformance became less pronounced as one moved out the credit curve.

The rout in energy prices continued to dominate credit headlines. Moody's largely concluded a sweeping global review of energy exploration and production companies which resulted in multi-notch downgrades for scores of issuers. Notably, Canadian Oil Sands, Cenovus and Encana were downgraded into junk status. Fears of contagion to the broader credit universe appear contained as Canadian bank provisions have ticked up but are well within historical norms, insurance energy exposures are manageable, and softening of the Alberta consumer has not dampened the credit profiles of retail, telecom, securitization and auto issuers.

Amidst an environment of elevated intra-day volatility, frequent issuers took advantage of periods of calm and the embedded demand due to corporate maturities (which have outpaced supply since the beginning of the year) to tap the primary market. A respectable $6.9 billion came to market in the month, with issuance emerging from higher rated issuers in infrastructure ($1.9 billion), autos ($1.4 billion) and domestic banks ($1.2 billion). Despite sizeable concessions and upsizing from original guidance, new deals generally had a moderate breadth of buyers and were unable to retrace concessionary pricing, putting acute pressure on secondary levels of similar issues. The fleeting nature of issuance opportunities during the month was exemplified by Corus Entertainment (scheduled to be only the third domestic high yield issuance in over a year) which postponed its heavily publicized $300 million deal until market conditions improved.

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 broad degradation in credit metrics. We do feel that in the near term corporate spreads will remain under pressure due to ongoing reduced liquidity and concessionary issuance, however volatile markets are acting as a disincentive for shareholder friendly initiatives. 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 continuing to be 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 nearly 2/3 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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Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com