January 31, 2016

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Risk-off sentiment prevailed over global risk assets, including Canadian credit, in January. During the month, domestic corporate spreads widened by an average of 17 basis points with increased aversion to issues with increasing maturity and declining credit quality. The global backdrop coupled with concessionary issuance saw the momentum of spread widening increase as the month progressed; however credit experienced some reprieve at month-end on the back of the Bank of Japan's negative interest rate policy announcement and a bounce of oil prices. Secondary market liquidity remains strained, with wide bid-ask spreads (particularly for higher beta issues), increased trading on an agency basis, and fleeting market rallies as a result of opportunistic selling by investors, who are heavily overweight corporates.

Amidst an environment of deteriorating sentiment towards credit, the domestic primary market stalled. For the month, an underwhelming $3.6 billion in four deals came to market. Issuance came from RBC and CIBC in the form of 5-year NVCC capital subordinated debt issues, Northwest Redwater in a two-tranche (13 and 24 year) issue and John Deere in the 3-year term. Despite sizeable concessions, the new deals had a limited breadth of buyers and performed poorly in after-market trading, putting acute pressure on secondary prices of similar issues. Given the shallow primary market depth and depreciating Canadian dollar, Canadian corporates (particularly the domestic banks) have increased issuance activity internationally; albeit not without a cost. This was highlighted by TransCanada, whom tapped the U.S. market with a $850 million, 10 year issue that was priced at 115 basis points more than compared to Canadian levels.

For the month, short, mid and long-term corporate yield spreads widened by 13, 22 and 15 basis points respectively, resulting in absolute returns of 0.04%, 0.07% and -0.04% respectively according to the FTSE TMX Canada All Corporate Bond Index. The underperformance of the mid-term area of the credit curve reflected its higher concentration of lower rated BBB credit (51%) versus the short (29%) and long-term (37%) areas. Absolute returns were bolstered by the rally in the underlying government yield curve. For the month, underlying 2, 5, and 10 and 30 year yields fell by 6, 17, 18 and 12 basis points respectively.

Risk aversion was evident in sector performance as more defensive, lower-beta, higher-rated issues in infrastructure and utilities generally outperformed across the curve. Telecom and cable also outperformed as Shaw's media asset divestiture allayed both supply and credit rating downgrade fears; and Rogers skipped a dividend increase to focus on debt reduction. In contrast, oil and gas producers, and pipelines underperformed as oil prices declined further. Relative performance on a ratings basis reflected sector moves as higher-rated debt outperformed across the curve. Outperformance was more pronounced moving out the credit curve as the spread widening between AA-BBB increased with term.

Outlook & Strategy

From the perspective of corporate fundamentals, we feel that we have surpassed the credit cycle peak. In the short term we expect that credit metrics will remain strong overall, with some deterioration of certain industries that are exposed to direct shocks. As such, low energy prices remain a concern on both macro and micro levels. However, we feel that, in the medium-term, the direct and indirect adverse impact of investment grade credit will be largely mitigated by generally strong credit profiles and limited concentration and counterparty risk. 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.

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 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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