LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

In the wake of positive macroeconomic data and indications of ongoing supportive monetary policy, the post-Brexit flight to quality observed in the credit markets subsided in July and domestic investors cautiously reached for yield. Canadian credit markets further benefitted from a significant uptick in international inflows as foreign investors searched globally for attractive yielding, high-grade debt. As a result, domestic corporate spreads ground tighter by an average of 5 bps during the month, with a predilection for higher beta, short and mid-term debt. Deteriorating corporate fundamentals has done little to alter the impulsive technical and macro event-risk driven investment behavior of yield hungry credit investors.

For the month, short, mid and long-term corporate yield spreads tightened by 5, 7 and 4 bps respectively, resulting in absolute returns of 0.25%, 0.56% and 1.88% respectively according to the FTSE TMX Canada All Corporate Bond Index. The bull steepening of the credit curve reflected a preference to increase corporate exposure via lower-rated, shorter-dated debt (where break-evens are more attractive relative to long bonds). Mid and long-term returns were bolstered by the flattening in the underlying government yield curve which saw 2 and 5 year yields rise by 2 and 3 bps respectively whereas 10 and 30 year yields fell by 3 and 8 bps respectively.

Across the yield curve, the best spread and absolute performance was reserved for higher yielding issues in energy exploration and generation – resumption of oil sands operations, telecom – liquid, higher beta proxy, and non-viability contingent capital (NVCC) bank debt – retracement of prior widening. Less liquid issues in real estate, retail – Sobeys, and infrastructure – government review of airport privatization, underperformed. On a rating basis the cautious reach for yield was evident as higher-yielding, lower-rated debt outperformed in the short-term area of the yield curve, whereas in the mid and long end A-rated debt outperformed.

Buoyed by foreign flows, pent up demand stemming from a dearth of bank issuance in Q2 (as they opportunistically tapped foreign markets) and attractive all-in-yields for issuers (relative to bank facilities), the new issue market saw $10 billion of fixed-rate bonds placed in July – a record for the month. However, highlighting the opportunistic nature of July's primary market issuance, there were no bonds issued with a term to maturity longer than 7 years. Issuance was dominated by the domestic banks, which priced $8.4 Billion in deposit notes, covered bonds and securitization vehicles. The latter included the inaugural issue of BMO's Fortified Trust ($750 Million), a real estate secured line of credit-backed notes. Significant issuance also emerged from auto finance (two issues totaling $800 Million), resulting in a record year to date for the sector on both an absolute basis and as a percentage of total corporate issuance.

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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