LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

In May, domestic credit spreads gave back some of their recent tightening due to: the view that the rally in corporates was overdone (the result of short-lived demand/supply imbalances); anticipated supply pressures; and fluctuating secondary market liquidity.

For the month, short, mid and long-term corporate yield spreads widened by 3, 6 and 8 bps respectively, resulting in absolute returns of 0.39%, 1.16% and 0.86% respectively according to the FTSE TMX Canada All Corporate Bond Index. The bear steepening of the credit curve reflected pressures from selling into anticipated long-term primary issuance and was exacerbated by already-thin secondary market liquidity. Absolute returns were bolstered by the rally in the underlying government yield curve which more than offset credit spread widening. For the month, underlying 2, 5, 10 and 30-year yields fell by 7, 13, 19 and 12 bps respectively.

On a sector basis, the best spread and absolute performance was reserved for pipelines (positive earnings, impact from Fort McMurray wildfire viewed as temporary) and as investors cautiously reached for yield - energy generation (TransAlta had slightly positive results) and higher yielding, A-rated insurance and subordinated bank debt. Alternatively, lower rated issues in real estate, auto (both impacted by supply pressures) and telecom (representing the most liquid lower- rated credit) underperformed. On a ratings basis, relative outperformance generally became more pronounced as one moved out the credit curve, as the widening basis between AA-BBB increased with term. Consequently, higher-yielding, lower-rated debt outperformed in the short-term area of the yield curve, while AA-rated debt outperformed in the long-term.

The usual staid infrastructure space was shaken by the news that Hospital Infrastructure Partners Partnership, which was mandated to design, build, finance and maintain the new Oakville, Ontario hospital was under review for downgrade from DBRS (A low) and S&P (A-) as a “default event” had occurred under the project’s service agreement. The event originated from a number of major service problems (flooding, HVAC) earlier this year and the service provider’s slow response. While rectifying plans are ongoing, and cash flows should not be affected, unless bondholders waive the current event of default, S&P has stated it will downgrade the project to D.

Despite low all-in borrowing costs and demand stemming from the June 1st technical bid (a combination of large coupon payments and index extension), only $5.8 Billion of new deals came to market, the lowest tally for May in five years. The softness in primary issuance can be partially attributed to the uptick in domestic issuers (particularly the banks) opportunistically tapping foreign markets. Notably, domestic banks have more than doubled European issuance this year over last year as they vie to reap the benefits of low rates and the ECB’s imminent corporate QE program. Domestically, significant issuance emerged from BMO ($1.25 Billion NVCC deal), Wells Fargo ($1 Billion Maple deal), Ford ($750 Million) and four issues from the real estate sector ($725 Million). All deals were heavily oversubscribed however they had mixed performance in secondary markets as they were launched with relatively smaller concessions than deals priced earlier this year.

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 as the largest rating 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 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, limiting exposure to higher beta credit out the credit curve, particularly for those issues with limited secondary market depth. Corporate yield spreads currently represent over sixty percent of absolute yields and thus provide good relative value. The portfolio is structured conservatively, possesses good liquidity, and is therefore, well positioned to capitalize on relative value and yield enhancement opportunities.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager