LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

The American presidential election cast a shadow over the domestic corporate market in November. Given the event risk leading up to the election, this manifested itself as heightened volatility (VIX neared Brexit-highs), falling yields, and sparse new issuance. Post-election, Trump's victory triggered a global bear steepening in sovereign yield curves as his fiscal stimulus and reduced regulatory policies will potentially increase economic growth, the deficit and inflation. With Global risk assets rallying and corporate bonds providing a degree of breakeven protection against rising bond yields, spreads tightened during the month. Canadian credit markets were further supported by the embedded demand stemming from the December 1st coupon payments and corresponding index extension. Overall domestic credit spreads tightened by an average of 7 basis points.

For the month, corporate yield spreads tightened by 6, 7 and 9 bps for the short, mid and long-term respectively. Narrowing corporate spreads were however, unable to completely offset the bear steepening effect of the underlying government yield curve as Canada 2, 5, 10 and 30 year yields rose by 15, 31, 38 and 32 bps respectively. All told, this resulted in absolute returns of –0.32%, –1.56% and –2.97% for the short, mid and long-term FTSE TMX Canada All Corporate Bond Indices respectively. The bull flattening of the credit curve reflected risk-on market sentiment and the need for longer duration bonds on the part of index funds, which often follows an index extension.

The pace of Canadian corporate issuance was slow to start the month as jitters over the US presidential election weighed on market sentiment. However, towards month-end, jumbo issuance emerged from the domestic banks (whom were no longer in earnings blackout), resulting in a healthy $8.9 Billion being issued for the month. This compared favourably with the $6.5 Billion issued in November on average for the last five years. Significant issuance emerged from BNS ($3 Billion, 5 and 10-year senior note), RBC ($1.3 Billion, 7-year senior note) and HSBC Holdings PLC ($1.0 Billion, 7-year for total loss-absorbing capacity eligible senior holdco debt). Canadian firms were also quite active south of the border as Enbridge ($1.5 Billion), Rogers ($500 Million) and Manulife ($300 Million) took advantage of attractive pricing relative to domestic new issue levels.

Across the yield curve, the best spread and absolute performance was reserved for sectors positively impacted by rising interest rates and a steeper yield curve (insurance and subordinated bank debt), reduced supply expectations (telecom and pipelines) and higher energy prices (energy exploration). Alternatively, real estate (negatively impacted by rising interest rates), infrastructure and utilities (higher-quality, lower beta) and senior bank debt (supply expectations) lagged. On a rating basis, risk-on sentiment was evident as higher-yielding, lower-rated debt generally outperformed across the credit curve.

Outlook & Strategy

The continuing degradation 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, however with the prospect of higher interest rates on the horizon this may be fleeting.

In this environment we foresee investors being cautious with exposure to higher levered debt out the credit curve, particularly for those issues with limited secondary market depth. Corporate spread levels currently represent over half of all-in-yields and thus provide good relative value. The portfolio has good liquidity and is structured conservatively with minimal exposure to sectors or issuers that would be negatively impacted in the event of higher interest rates. It is therefore well positioned to capitalize on relative value and yield enhancement opportunities.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

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