October 31, 2016

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

A bear steepening yield curve provided the impetus for fixed income investors to increase their exposure to corporates, where break-evens (the level by which yields would need to rise in a given period in order to generate a negative return) offered some protection against rising yields. Canadian credit markets were further buoyed by a dearth of primary issuance. As a result, domestic corporate spreads ground tighter by an average of 6 bps during the month, with a predilection for higher beta, short and mid-term debt. Deteriorating corporate fundamentals did 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 6, 8 and 3 bps respectively, resulting in absolute returns of 0.17%, -0.23% and -1.65% 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 those for long bonds. Overall returns were however, dampened by the bear steepening of the underlying government yield curve which saw 2,5,10 and 30 year yields rise by 3, 8, 20 and 19 bps respectively.

During the month, the Ministry of Finance announced a number of changes to residential mortgage insurance eligibility requirements in an effort to reduce cyclicality in the housing markets. Tougher insurance rules, which will likely reduce mortgage originations, negatively impacted the spreads of mortgage lenders – Home Capital, First National, Equitable Group and Genworth spreads widened by 10-30 bps. In contrast, spreads for NHA MBS insured mortgage pools created by lenders (primarily banks) tightened by 5 bps on reduced supply expectations. The Federal Government also announced it was launching a public consultation on lender risk sharing. The redistribution of risks will ultimately lead to banks holding a modestly higher amount of capital against insured mortgages but is relatively neutral from a credit perspective.

Across the yield curve, the best spread and absolute performance was reserved for higher yielding issues in energy exploration and pipelines (aided by a rebound in oil prices) and communications (some retracement of prior Shaw widening). Less liquid issues in financial services such as mortgage lenders, retail (Sobeys) and real estate had weaker performance. On a rating basis the reach for yield was evident as higher-yielding, lower rated debt generally outperformed across the curve, with the degree of relative outperformance decreasing with the increase in term.

The pace of corporate issuance slowed in October with only $4.5 billion of new issuance placed during the month. The decline was due in part to corporates being in blackout as they head into earnings season and the difficulty that both issuers and buyers alike faced in navigating underlying rate volatility. Significant issuance did emerge from BMO ($2 Billion, 5-year senior note), Wells Fargo ($1 Billion, 7-year senior note) and Kingston Solar LP ($633 million, 10.4-year amortizer). The Wells Fargo maple deal was notable as its pricing implied that investors have largely shrugged off recent negative headlines and outlook revisions from S&P.

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 stemming from a reach for yield and international flows which may be fleeting.

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 is, therefore, well positioned to capitalize on relative value and yield enhancement opportunities.

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