LORICA | INVESTMENT COUNSEL INC.

# Focused Corporate Bond

## Market Highlights

During Q3, elevated event risk and deteriorating credit fundamentals in the Canadian corporate market took a backseat to the pursuit for yield. Throughout most of quarter, beginning in July, corporate yield spreads steadily ground tighter, as sovereign yields near historic lows, ongoing supportive monetary policy (e.g. expansion of the Bank of England's QE program), and decent corporate earnings, lured domestic investors out the credit curve, as they reached for yield. Domestic credit markets were further buoyed by an uptick in international inflows from foreign investors searching for attractive yielding, high-grade debt. However, going into quarter-end, corporate spreads came under pressure due to contagion risk relating to indications that the BoJ and ECB were reviewing the structural repercussions of maintaining a flat yield curve and later on over concerns relating to the capitalization of Deutsche Bank. All told, corporate spreads narrowed by 10 basis points during the quarter, with investors having a preference for liquid, higher-yielding, higher beta debt.

For the quarter, short, mid and long-term corporate yield spreads narrowed by 9, 11 and 9 bps respectively, resulting in absolute returns of 0.80%, 1.52% and 3.21% respectively according to the FTSE TMX Canada All Corporate Bond Index. The outperformance of the mid-term area of the credit curve reflected its higher concentration of outperforming BBB credit (53%) versus the short-term (31%) and long-term (38%) areas. Absolute returns were bolstered by the small bull flattening of the underlying government yield curve. For the quarter 2 and 5-year yields were flat whereas 10 and 30-year government yields fell by 6 and 5 bps respectively.

Across the yield curve, the best spread and absolute performance was generally reserved for higher beta sectors and securities – oil and gas producers (oil consolidating recent price gains), pipelines (Enbridge/Spectra deal expected to improve credit metrics) and subordinated bank hybrid debt (reduced supply expectations). Alternatively, less liquid issues in retail (Sobeys continuing struggles with its integration of Safeway), real estate (office REITS), and infrastructure (government review of airport privatization) underperformed. Relative performance on a ratings basis reflected sector moves, as lower rated debt outperformed across the credit curve, with the outperformance diminishing with the increase in maturity (for lower-rated debt, shorter maturities are more attractive).

After a record breaking summer, primary issuance was underwhelming in September, having been severely impacted by negative Deutsche Bank headlines and rate volatility. Of the $22 Billion that was issued in Q3, significant issuance emerged from the domestic banks ($9.4 Billion), oil and gas ($2 Billion) and autos ($1.7 Billion).

## Portfolio Activity

On the back of supply pressure, the portfolio opportunistically increased exposure to short-term, higher-yielding auto and subordinated insurance debt and reduced exposure to legacy subordinated bank debt. The portfolio's duration and yield curve bias was maintained.

## What Worked In The Quarter

The portfolio's benefitted from its sector exposure, as it was overweight in top-performing pipelines, and subordinated bank and insurance debt. The portfolio had no exposure to underperforming real estate, retail and airport issuers.

## What Didn't Work In The Quarter

Relative to the index, the portfolio was more conservatively structured with a relatively short duration and an overweight in the 5-year area of the yield curve in lieu of long bonds. Long-term corporate yields declined by 15 bps.

## 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 supply/demand imbalance stemming from a reach for yield and corresponding international flows which may be fleeting.

In this environment we foresee investors being cautious with exposure to higher beta credit with weaker credit quality, 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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