April 30, 2017

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Canadian credit markets were undeterred in the face of mounting event risk, both foreign – North Korean saber rattling and French elections, and domestic – Home Capital and US/Canadian trade disputes, as the reach for yield took precedent. Risk-on sentiment was further augmented by a dearth of primary issuance during the month. Overall, corporate spreads narrowed by 5 basis points in April, in a move most aptly described as aggressive, given investor's bias for higher-beta longer-dated lower-rated credit. The *bull flattening* of the credit curve reflected investor preference, as short, mid and long-term corporate yield spreads tightened by 3, 4 and 8 bps respectively for the month. Returns were bolstered by the decline of underlying government yields (2, 5, 10 and 30-year yields fell by 7, 12, 20 and 15 bps respectively) resulting in returns of 0.51%, 1.64% and 3.56% for short, mid and long-term corporates.

Many investors were caught off-guard by Home Capital's announcement that due to material outflows of on-demand deposits, it would be securing an onerous $2 Billion credit line from a pension fund and retained advisors to explore financing and strategic options. On the back of the news, their bonds were downgraded deep into junk territory by S&P and DBRS. Given that the credit line is not cost-efficient and unlikely to be a viable long-term funding solution, term debt holders of bonds and non-redeemable GIC's will wait for either a buyout, an orderly liquidation, or management to use liquid and maturing assets to cover these liabilities as they become due. Home Capital's woes put pressure on the yield spreads of other mortgage lenders (e.g. Equitable Group, Genworth, MCAP and First National) however broader market contagion appeared contained.

One of the popular funding tools used by lenders in other jurisdictions – residential mortgage backed securities (RMBS) – is unfortunately unavailable to Canadian issuers due to the poor development of the domestic market. However, in early April, the Bank of Montreal took steps that may be a catalyst to reopen this market by packaging (and retaining most of) $2 billion uninsured fixed-rate mortgages through a newly created RMBS structure called Bicentennial Trust. Prior to BMO's initiative, uninsured mortgages were principally securitized by large banks through covered bonds, which similarly include recourse to the mortgage pool, but also include recourse to the highly rated bank.

Across the yield curve, the best spread and absolute performance was reserved for higher-yielding issues in telecom, pipelines and energy generation. While, mortgage lenders and real estate issuers broadly underperformed across the curve owing to the recent Home Capital events. On a rating basis, risk-on sentiment was evident as higher-yielding, lower-rated debt generally outperformed across the credit curve.

Primary market issuance of $5.4 Billion was unable to satiate underlying investor demand. Domestic bank issuance continued to disappoint, as issuers took advantage of attractive funding levels abroad and continued to await further clarity on the bail-in process before tapping the domestic market. Several US financial issuers took advantage of the pent-up Canadian demand through Maple issuance; i.e. Wells Fargo ($1 Billion) and Goldman Sachs ($750 Million). Outside of financial deals, supply was dominated by BBB-rated issues – a consistent trend as of late.

Outlook & Strategy

Eroding credit metrics coupled with the growth of BBB-rated debt has made the domestic corporate market more sensitive to global event risk. We feel that, near-term, there is an increased risk that corporate spreads will be pressured, given they are currently buoyed by a supply/demand imbalance, which with the prospect of higher interest rates on the horizon, may be fleeting.

In the current 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. However, corporate yield spreads, which currently represent half of all-in yields, provide good relative value. The portfolio possesses 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; and is well positioned to capitalize on relative value and yield enhancement opportunities.

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