LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Risk tone was soft in August as a string of unexpectedly strong Canadian economic data points and generally positive earnings releases was overshadowed by events south of the border – disappointing CPI report, debt ceiling concerns and Charlottesville, and internationally – North Korea and Barcelona terrorist attacks. Domestic credit spreads were further pressured as the market struggled to digest the sizable $5.3 Billion of new issues during a month which typically has thin liquidity. For the month, domestic corporate yield spreads widened by an average of 3 bps, with a notable preference amongst investors to take on term risk versus credit risk causing longer-term, higher beta bonds to underperform. In general, the movement of domestic credit spreads continues to be largely driven more by macro and supply factors than micro trends.

The cautious market tone during August, resulted in wider corporate yield spreads and bear steepening of the credit curve – short, mid and long-term corporate spreads widened by 2, 3 and 5 bps respectively. The negative impact of widening corporate spreads however, was more than offset by the bull flattening of the underlying government yield curve (2, 5, 10 and 30-year yields declined by 4, 17, 21 and 21 bps respectively) resulting in absolute returns of 0.46%, 1.29% and 2.41% respectively according to the FTSE TMX Canada All Corporate Bond Index.

Risk aversion was evident in sector performance as more defensive, lower-beta, higher-rated issues in infrastructure and utilities generally outperformed across the curve. Domestic banks also broadly outperformed as earnings produced few negative surprises and expected supply did not materialize (foreign markets were more attractive).

Notably, Cominar REIT, which had seen its spreads widen dramatically this year over concerns it would be downgraded to junk, was finally downgraded by DBRS to BB (high) from BBB (low) following Q2 results. Spreads widened on the news; however they experienced a relief rally late in the month, as Cominar looked to regroup and announced non-core asset divestitures that would be utilized for debt reduction and reinvestment in its core markets.

Higher beta, longer-term, lower rated issues in telecom – most liquid of beta sectors, and pipelines – refinery disruptions underperformed. Despite beating consensus earnings estimates, insurance also broadly underperformed due to the pressure lower interest rates put on discount rates used in actuarial assumptions. Relative performance on a ratings basis reflected the cautious market stance with a bias towards higher credit quality moving out the credit curve where spread widening between AA-BBB credit became more pronounced.

Amidst an environment of elevated intra-day volatility, opportunistic issuers took advantage of periods of calm and got ahead of an expected busy pipeline of issuance in September. A sizable $5.3 Billion in fixed-rate issuance was priced in the month, with significant issues from Apple ($2.5 Billion), Fédération des Caisses Desjardins ($850 Million), Manulife ($750 Million) and Pembina Pipelines ($600 Million over two tranches). Despite sizeable concessions and upsizing from original guidance, new deals generally were unable to retrace concessionary pricing, putting acute pressure on secondary levels of similar issues.

Apple's 7-year Canadian dollar issuer was notable as it tied RBC for the largest single tranche transaction in the Canadian market. Apple was attracted to the Canadian market as it could price its bonds at 80 bps over Government of Canada's – at a premium (roughly 14 bps rich to existing US$ issues on a swapped equivalent basis) Canadian investors were willing to pay for the diversification the name provided.

Outlook & Strategy

Elevated 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, near-term, there is an increased risk that corporate spreads will be pressured as they are currently buoyed by a supply/demand imbalance, which, with the prospect of higher interest rates on the horizon, may be fleeting. The front-end of the Canadian yield curve has already responded to the Bank of Canada's more hawkish tone; however we expect the back-end of the yield curve to catch-up with the rise in the front-end as the yield curve is too flat in our view.

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. However, corporate spread levels, which currently represent about forty percent of all-in yields, still provide good relative value and protection against rising yields. Overall, 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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