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LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Fading optimism over the Trump stimulus plan and concerns of a populist win in the French presidential elections did not overshadow the plethora of positive macroeconomic data. Domestic credit spreads followed the rally in global risk assets, tightening by an average of 5 basis points during the month. Canadian credit markets further benefitted from a dearth of primary issuance and from an uptick in international inflows as foreign investors searched globally for attractive yielding, high-grade debt.

For the month, short, mid and long-term corporate yield spreads tightened by 5, 4 and 4 bps respectively. The parallel shift tighter of the credit curve relative to government bonds was representative of the broad-based risk-on market sentiment. Corporate returns were further buoyed by the bull flattening of the underlying government yield curve as Canada 2, 5, 10 and 30 year yields fell by 3, 8, 13 and 7 bps respectively. All told, the market moves resulted in absolute returns of 0.47%, 1.26% and 1.87% for the short, mid and long-term FTSE TMX Canada All Corporate Bond Indices, respectively.

Across the yield curve, the best spread and absolute performance was reserved for higher-yielding, lower-rated debt in energy generation (Algonquin Power, TransAlta) and retail (Sobey's). Sectors (insurance and subordinated bank debt) positively impacted by rising interest rates and a steeper yield curve outperformed; while, defensive higher-quality issuers (infrastructure and utilities) lagged. On a ratings basis, risk-on sentiment was clearly evident as higher-yielding, lower-rated debt generally outperformed across the credit curve.

Q1 domestic bank results were credit neutral as positive trends in profitability, asset quality and capital positions were largely offset by increased dividend and share buyback intentions. From a regulatory perspective, upcoming quarters will likely be active as we await final policy decisions and guidance on lender risk sharing and the transition period for senior bail-in debt from the Department of Finance and OSFI. Issuance of Bail-in Debt – assuming the Higher Loss Absorbency requirement is set at the higher end of the 17%-23% range of risk-weighted assets – will effectively replace domestic senior deposit funding in the years ahead.

With many issuers in earnings blackout, the pace of domestic investment grade corporate issuance slowed to $4.8 Billion for the month. Significant issuance emerged from Bell Canada ($1.5 Billion across two tranches), Ford ($750 Million), Bruce Power ($750 Million across two tranches), Toyota ($600 Million) and EnerCare Inc. ($500 Million across two tranches). The net proceeds of the jumbo Bell Canada deal are to be used to partially fund the acquisition of Manitoba Telecom Services, approved by the Competition Bureau during the month. Generally, all new issues were priced at the tight end of guidance, were significantly oversubscribed, and performed well in the secondary market.

Outlook & Strategy

Eroding 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.

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 almost 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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