



**LORICA** | INVESTMENT  
COUNSEL INC.

## Focused Corporate Bond

### Market Highlights

With the Trump transition in focus, equity and corporate bond markets rallied on cues that the Trump administration is intent on following through on its desire to implement a significant economic stimulus program. Canadian credit spreads were further buoyed by the technical bid stemming from the annual New Year's increase in corporate bond investor risk appetite. All told, corporate spreads narrowed by 8 basis points during January, with investors having a preference for liquid, higher-yielding, higher beta debt. For the month, short, mid and long-term corporate yield spreads narrowed by 8, 8 and 7 bps respectively. In the long-end, corporate returns were dampened by the steepening effect of the underlying government yield curve as Government 10 and 30-year yields rose by 4 and 10 bps respectively. All told, absolute returns were 0.42%, 0.76% and 0.15% for the short, mid and long-term FTSE TMX Canada All Corporate Bond Indices respectively. In the current environment, corporate bonds, particularly short-term, higher-beta debt, provided a degree of break-even protection for rising bond yields. The bull steepening of the credit curve reflected investor preference for short and mid-term corporate exposure.

Across the yield curve, the best spread and absolute performance was reserved for sectors positively impacted by rising interest rates and a steeper yield curve (insurance and subordinated bank debt); and higher-yielding, lower rated debt in energy exploration, generation and retail (e.g. Sobey's). In contrast, defensive, higher-quality issuers in the infrastructure and utilities space lagged. On a rating basis, risk-on sentiment was evident as higher-yielding, lower-rated debt generally outperformed across the credit curve.

While it will take some time before Canada gets a better sense on how Trump's campaign platform rhetoric will transform into trade policy, one of his first executive orders, acceleration of approval for TransCanada's Keystone XL pipeline, will have a direct impact on Canada. Although the order gave an

immediate boost to the Canadian Dollar, the impact on TransCanada credit was muted as too many questions relating to federal and state regulatory approvals, legal challenges from special interest groups, evolving capital costs, and most importantly, terms of the Keystone XL proposal the Trump administration will renegotiate.

The momentum in the secondary market carried through to the primary market which saw \$6.9 Billion of fixed-rate corporate bonds priced for the month. Significant issuance emerged from the banks (CIBC, BNS and Canadian Western Bank deposit notes totaling \$1.9 billion), Fédération des Caisses Desjardins du Québec (\$1 Billion), Morgan Stanley (\$1 Billion) and Pembina Pipelines (\$600 Million in two tranches). Domestic banks were also active internationally, issuing \$14 Billion of fixed and floating rate debt during the month. This foreign issuance continues a trend we've seen over the last few years of domestic banks doing the lion's share of their funding outside of the domestic market as foreign funding costs remain relatively attractive versus domestic levels.

### 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 in the near term there is increased risk that corporate spreads will be pressured as they are currently buoyed by a demand/supply imbalance and with the prospect of higher interest rates on the horizon this may be fleeting.

In this environment we expect investors to be cautious with exposure to higher levered credit with longer maturities, particularly for those issues with limited secondary market depth. Corporate spread levels currently represent almost half of all-in-yields and thus 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. It is therefore well positioned to capitalize on relative value and yield enhancement opportunities.