LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Motivated by relatively strong macroeconomic data, the Bank of Canada announced its first rate hike in seven years, causing the government yield curve to steepen on the month, led by a bigger increase in longer-term yields. Given the degree of protection against rising yields offered by corporate bonds, domestic credit spreads tightened over the period. Corporates were further buoyed by a constructive earnings tone, higher commodity prices, and modest new issuance activity.

Overall, domestic credit spreads tightened by an average of 5 basis points during the month, with higher-yielding, lower-rated debt generally outperforming across the credit curve. Along the curve, yield spreads tightened by 5, 5 and 4 bps for short, mid and long-term issues respectively. The parallel shift of the credit curve reflected the broad appeal credit traditionally has during periods of rising yields as it provides a degree of downside protection through its higher yield carry and spread support from an improving macro backdrop.

Narrowing corporate spreads were unable to completely offset the rising and steepening of the underlying government yield curve, where Canada 2, 5, 10 and 30 year yields rose by 19, 27, 31 and 34 bps respectively. All told, the short, mid and long-term FTSE TMX Canada All Corporate Bond Indices returned –0.33%, –1.20% and –3.57% respectively.

Across the yield curve, the best spread and absolute performance was reserved for higher-yielding, lower rated issues in oil and gas – improvement in energy prices, and retail – rebound in June's underperformance due in part to Amazon's acquisition of Whole Foods. Alternatively, infrastructure and utilities – i.e. higher-quality and lower beta – lagged. Within the infrastructure sector, Hydro One notably underperformed its peer group due to its announced acquisition of US power supplier Avista for $5.3 Billion. Although the acquisition will be financed at the holdco. level in the US and should have no impact on the credit metrics of the operating company (entity from which the $C bonds are issued), Moody's and S&P both revised their outlooks to negative due to the shift in business strategy and the probability of extraordinary support from the Province of Ontario being reduced.

The new issue market remained healthy with $7.7 Billion priced for July, which while off from last year's July record of $10 Billion, equaled the average issued for July over the last five years.

Spurred by recent introduction of draft regulations on bail-in, jumbo deposit notes were issued by BMO ($2 Billion) and CIBC ($1.75 Billion). Investor demand was strong for these legacy securities which will not be subject to the expected bail-in provisions. Also in the financial sector, TD Bank issued the first NVCC issue to be included in the index, a $1.5 Billion issue. Demand for the TD issue was further bolstered by the announcement that NVCC bonds issued prior to July 1st would be eligible for inclusion in the Universe Bond Index with a targeted inclusion date of February 2018.

The other notable issue was Alimentation Couche-Tard's $700 Million $C bond issue, which was part of a $3.25 Billion dual $C and $USD dollar transaction related the CST Brands acquisition.

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, given our view that the yield curve is too.

We expect investors to be cautious with exposure to higher levered debt, particularly for longer maturities and those issues with limited secondary market depth. However, corporate spread levels, which currently represent about forty percent of all-in yields, provide good relative value and protection against spread widening. 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.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com