May 31, 2017

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Domestic corporate bonds began May on a positive footing as strong US and Canadian employment reports, a hawkish Fed, supportive French election results and few signs of systemic risk resulting from Home Capital's woes, led to a selloff in government yields and a rally in higher-beta corporate yields spreads. Sentiment thereafter, soured with Moody's broad downgrade of Canadian banks, weakening energy prices and escalating geopolitical concerns – Trump's firing of FBI Director Comey and successful North Korean ballistic missile tests. Further weighing on corporate bonds was record new issuance led by a deluge of Maple (foreign issuer Canadian dollar denominated) and lower-rated issues.

Collectively, corporate spreads widened by an average of 7 basis points over the month, with short, mid and long-term corporate yield spreads gapping out by 7, 9 and 5 bps respectively. The "bear flattening" of the mid-to-long part of the credit curve reflected the embedded demand for long bonds stemming from the June 1st coupon payment and corresponding index extension. Although investors generally sought the liquid duration-heavy provincial sector as the preferred means to get long credit exposure. Corporate returns were bolstered by the rally in underlying Canada bonds with 2, 5, 10 and 30 year yields falling by 2, 8, 12, and 10 bps respectively. May returns for the FTSE Russell Corporate Short, Mid and Long indices were 0.09%, 0.61% and 1.09% respectively.

Fears of broader market contagion from Home Capital's funding issues eventually subsided, with concerns limited to mortgage lenders and real estate issuers. However, there was ample unfavourable news in the corporate sector to reinforce an overall negative sentiment. For example: Aimia's loss of exclusive Air Canada Aeroplan contract; Cominar REIT's results which increased worries over downgrade to junk; Granite REIT's activist investor actions; North West Redwater Partnership's downgrade to BBB+ by S&P; GM/Daimler's "emission defeat device" allegations; and most notably, Moody's ratings downgrades of the Big 6 Canadian banks (citing high levels of consumer debt and record home prices left lenders vulnerable to potential credit losses).

Across the yield curve, the best spread and absolute performance was reserved for defensive issues in infrastructure and utilities. Conversely, the afore-mentioned negative news resulted in underperformance of real estate, senior and subordinated bank debt and autos. The oil and gas sector also came under pressure due to retreating energy prices and selling related to new issuance from Canadian Natural Resources ($1.8 Billion) and North West Redwater Partnership ($1.5 Billion). Performance on a rating basis reflected heightened risk aversion and sector moves as A-rated debt generally outperformed across the credit curve.

May's record new issuance of $14.3 Billion was driven by hefty issuance from Maples ($4.8 Billion) and BBB-rated debt ($6.7 Billion including downgraded NWRP). Maple issuers have typically tapped the Canadian market as a source of diversification with funding levels that compare favorably to those obtained in their primary home market. The uptick we've seen in Maple issuance (to pre-credit crisis levels) as of late has been from US based issuers and is a byproduct of expected US tax reforms. Given expectations that the US corporate tax rate will be reduced, the benefit of deducting interest expenses is expected to diminish, thereby putting a greater focus on funding levels and diversification of funding sources.

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 also 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 more than 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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