LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Headwinds from exports, housing and NAFTA negotiations prompted the Bank of Canada to assert that it would be cautious in future policy moves. This was juxtaposed to the upbeat comments from the Fed ahead of a strong GDP report. The divergent views resulted in a shift lower of the Canada government yield curve whereas US yields rose. Amidst this upbeat assessment of the US economy, risk assets rallied and domestic credit spreads followed suit, tightening by an average of 4 basis points during the month. Canadian credit markets further benefitted from a dearth of bank issuance and lower government yields fueling investors to reach for yield.

For the month, short, mid and long-term corporate yield spreads tightened by 5, 3 and 4 basis points respectively. The parallel shift tighter of the credit curve, relative to government bonds, was representative of the broad-based risk-on market sentiment and reach for yield. 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 14, 13, 14 and 17 bps respectively. All told, this resulted in absolute returns of 0.74%, 1.51% and 3.15% 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 came from higher yielding issuers in energy generation, oil and gas, autos and NVCC subordinated bank debt. In contrast, more defensive infrastructure issues modestly underperformed. Notably, Enbridge Income Fund spreads widened by 2-7 basis points across the credit curve as it was downgraded to Baa3 from Baa2 by Moody's (high leverage and ongoing execution risks on the Line 3 Replacement project). Enbridge Inc. and affiliates were unaffected by the downgrade. On a ratings basis, the variance between performance was narrow across the yield curve with BBB-rated debt slightly outperforming in the short-end, whereas A-rated debt marginally outperformed in the long-term area.

Domestic banks continued to be active in foreign markets (given the market's attraction on a relative pricing basis while also providing funding diversification) ahead of their fiscal year ends. As a result, the pace of fixed-rate issuance slowed in October to $5.4 Billion. Significant issuance emerged from pipelines ($1.1 Billion), autos ($900 Million), securitization ($700 Million) and Maple (foreign issuer Canadian dollar) bonds ($2 Billion). The latter comprised of issues from Goldman Sachs ($750 Million) and an inaugural Walt Disney issue ($1.25 Billion). Industrial Maples continue to be attracted to the Canadian market as domestic investors are willing to pay a premium (relative to US$ issues) for diversification.

The most notable issuance from a domestic issuer during the month occurred, not in Canada's primary market, but south of the border, where BNS priced a $1.25 Billion additional tier-1 (AT1) NVCC hybrid bond – the first for a domestic bank in the US. The BNS notes are designed to be a Basel III eligible source of AT1 capital, a role currently filled exclusively by more costly NVCC preferred shares. In the event of insolvency, the bond will rank ahead of preferred shares but will be junior to existing NVCC sub-debt. Considering the breadth of buyers and attractive pricing that the US$ AT1 bond market affords, the success of this issue may mark the beginning of a structural shift away from the domestic preferred market for banks.

Outlook & Strategy

There is an increased risk that corporate spreads will be pressured as they have been buoyed by a supply/demand imbalance, driven by monetary accommodation, which, with the prospect of higher interest rates on the horizon, may be fleeting. Elevated credit metrics coupled with the growth of the BBB-rated debt class has also made the domestic corporate market more sensitive to global event risk. In recognition of these near-term risks and with the expectation that the Canadian yield curve will steepen, the portfolio will retain its duration, yield curve steepening and credit quality bias.

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, 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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