LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

After two months of heightened volatility, domestic credit tone improved in April as trade and geopolitical worries abated. Corporate spreads were relatively stable, narrowing by a basis point, on average, across the yield curve. Moderate primary corporate issuance of $7.5B combined with the bear steepening of the government yield curve: 2, 5, 10, 30-year yields rose by 7, 15, 19 and 17 basis points respectively, supported the corporate market during the month. (Investors look to corporate yield spreads as a means of gaining additional protection against rising underlying Canada yields.)

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 banking; and higher-yielding, lower rated sectors: media and retail. Telecom also broadly outperformed as Bell Canada's inaugural US (30-year) issuance, reduced domestic supply expectations for the sector going forward. In contrast, concessionary domestic supply weighed on pipeline issuers. TransCanada notably underperformed as management confirmed on the Q1 earnings call that they were anticipating a rating downgrade from S&P.

Airport credit weakened as the federal government officially abandoned its two-year privatisation study. Canadian airports are operated by non-profit, non-share capital corporations, which lease airport lands from the federal government. A conversion to share capital corporations and selling of equity stakes was forecast to raise $7-$16B, with the proceeds directed to future infrastructure investment. In a conversion, bondholder consent is required, opening the potential for the realization of deep call premiums. We expect further pressure on airport credit spreads given that supply expectations for the sector materially increased at month-end, following the Aeroports de Montreal announcement of an expansion to be financed by, an estimated, $2 billion of long-term debt.

Another ongoing credit story which saw developments during April relates to bail-in debt and the release of the final regulations by the Department of Finance, which come into force in late September of this year. Unlike, non-viability contingent capital, according to the regulations, bail-in debt will not include a fixed conversion multiplier to equity (the CDIC will determine the conversion rate at the time of resolution), thereby increasing dilution risk for subordinated securities. In addition, banks will be required to make deductions and carveouts for holdings in their own or other banks' *loss-absorbing*, debt which may have negative implications for liquidity of bail-in debt. We anticipate bail-in debt will be issued at a material discount to legacy senior bank debt which will also likely pressure the broader corporate market as bank debt is typically used as reference point for pricing corporate debt.

Outlook & Strategy

Corporate spreads have been supported by a monetary policy accommodation driven supply/demand imbalance, which, with the prospect of higher interest rates on the horizon, may not persist. Elevated leverage metrics, coupled with the growth of the BBB-rated debt class have also made the domestic corporate market more sensitive to global event risk and higher interest rates, while eroding debt-service capacity.

In this environment, we foresee investors being cautious with exposure to higher levered debt along the credit curve, particularly for those issues with limited secondary market depth. However, corporate spreads, which currently represent just over 35% 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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