LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Volatility surged to the highest levels since 2015 as rising interest rates weighed on global risk assets. Global bond markets have been broadly under pressure due to pervading concerns over the "great central bank unwind" and increased Treasury supply. Strong monthly US CPI and average hourly earnings readings further stoked Fed rate hike fears. Whereas Treasuries saw a backup in yields, Canadian bond yields fell in February (albeit with a steepening curve bias) due to weak economic data and uncertainty over NAFTA negotiations. Amid the equity selloff, high grade domestic credit spreads widened by a comparatively tame: 6 basis points, as the stock decline was viewed as a necessary pullback versus no real deterioration in credit cycle fundamentals. Secondary market liquidity was however, strained, with wide bid-ask levels (particularly for higher beta issues), increased trading on an agency basis, and fleeting market rallies – the result of investor's (who are heavily overweight corporates) selling opportunistically.

For the month, short, mid and long-term corporate yield spreads widened by 8, 6 and 5 basis points respectively. The shift wider of the credit curve relative to the government curve was reflective of the broad-based risk-off sentiment. Corporate spread widening in the short and mid-term area was however, more than offset by the twisting government yield curve as Canada 2, 5 and 10 year yields fell by 6, 8, and 6 bps respectively and the 30-year yield was flat. Absolute returns were -0.2%, 0.3% and -0.5% for the short, mid and long-term FTSE TMX Canada All Corporate Bond Indices, respectively.

Risk aversion was evident in sector performance as more defensive, lower-beta, higher-rated issues in infrastructure and utilities generally outperformed across the curve. In contrast, higher-beta debt in real estate, retail, and bank non-viable contingent capital (NVCC) underperformed. The NVCC underperformance was notable as the index inclusion of $16 Billion of legacy NVCC bonds during the month did not lead to a strong technical bid. Liquid sectors: senior bank deposit notes, telecom, also generally underperformed as investors reduced credit exposure through these corporate proxies, versus attempting to sell illiquid bonds.

Amidst an environment of elevated intra-day volatility and deteriorating sentiment for most of the month, the domestic primary market stalled. With a few days to month-end, issuance was the lowest for a February in a decade. A period of calm then emerged and frequent issuers tapped the primary market, taking advantage of the embedded demand for bonds stemming from March 1st coupon payments, and the resulting index extension. A total of $5.4 Billion was priced for the month with significant issuance emerging from the domestic banks ($1.3 Billion), autos ($1 Billion) and telecom ($750 Million). Notably, Fair Hydro Trust (a single purpose trust established to finance Ontario's Fair Hydro Plan) priced its inaugural issue. Despite material spread concessions and heavy oversubscription, new deals generally had a moderate breadth of buyers and were unable to retrace concessionary pricing, thereby putting acute pressure on secondary levels of similar issues.

Outlook & Strategy

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

In the current 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 thirty-five 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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