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LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Amidst a backdrop of strong macroeconomic data, US tax cuts and an uptick in corporate earnings growth, risk-on sentiment prevailed over global risk assets, including Canadian credit, in January. Canadian credit spreads were further buoyed by foreign buying, rising commodity prices and the technical bid stemming from the annual New Year's increase in corporate bond investor risk appetite. The momentum of spread tightening however, slowed into month-end amid interest rate hike fears and increased primary issuance. Notably, lower rated debt came under pressure in the final days of the month as the market reassessed the impact on credit profiles of a rapid normalization in rates. All told, domestic corporate spreads tightened by an average of 8 bps during the month with higher beta debt broadly outperforming across the credit curve.

For the month, short, mid and long-term corporate yield spreads tightened by 7, 9 and 7 bps respectively. The narrowing of corporate yield spreads evenly across the yield curve was reflective of the broad-based risk-on sentiment and credit's appeal during periods of rising interest rates. Traditionally, credit is viewed favourably during periods of rate increases and improving economic fundamentals, as they provide a greater degree of downside protection through higher yield carry and spread support. However, corporate spread tightening was more than offset by rising Canada yields as 2, 5, 10 and 30-year yields rose by 12, 22, 25 and 9 bps respectively. This resulted in absolute returns of -0.07%, -0.58% and -0.32% for the short, mid and long-term FTSE TMX Canada All Corporate Bond Indices respectively.

An increased appetite for risk was evident in sector performance as higher-yielding, lower rated issues in oil and gas, real estate, pipelines and telecom broadly outperformed. Sectors positively impacted by rising interest rates (and a steeper yield curve) – insurance and senior/subordinated bank debt - also generally outperformed. Bank debt was bolstered by the Bank of Canada rate hike, which led international investors to buy shorter-dated bank deposit notes and in turn, gain exposure to the strong Canadian dollar. Alternatively, higher rated, defensive issues in infrastructure, utilities and securitization broadly underperformed. Financial services also underperformed, primarily due to GE Capital's woes related to charges for the unexpected run-off of its insurance portfolio and its ongoing restructuring plan.

The primary market was quiet for the first half of the month as the market awaited the Bank of Canada interest rate decision and domestic banks took advantage of attractive funding levels abroad. With uncertainty out of the way following the rate hike (and dovish comments), issuance ramped up, resulting in $6.2 Billion of new issues for the month. Significant issuance emerged from the domestic banks ($3.25 Billion), real estate ($1.4 Billion) and autos ($700 Million). Despite material spread concessions and heavy oversubscription, many issues were unable to retrace concessionary pricing due to overall market moves, putting acute pressure on secondary prices of similar issues.

Outlook & Strategy

There is an increased risk that corporate spreads will be pressured as they have been buoyed by (a 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, 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 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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