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LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Domestic credit remained relatively resilient amidst US-China trade tensions and softer overseas PMI data. European rates were pushed further into negative territory and forced some European investors – primarily regulated institutions and pension funds – to shun the basic principles of the global finance system (adopting a greater fool theory of investing). Fortunately, the reaction to increased risk aversion was more rationale on this side of the Atlantic as speculative asset classes (US$ global high yield, leveraged loans) saw negative returns, materially underperforming investment grade credit.

For the month, short, mid and long-term corporate yields fell by 11, 17, and 16 basis points as the underlying Government of Canada curve bull flattened and resulted in a return of 0.82% for the portfolio. The Canada curve flattening echoed similar moves of the Treasury curve, albeit to much a lesser degree which is reasonable given our economic, inflation and household debt numbers are less conducive for a rate cut than in the US. Strength in the underlying economy has also fed into domestic earnings outlooks and a slight improvement in business sentiment (as per the most recent Bank of Canada Business Outlook Survey). Domestic credit continues to be underpinned by the composition of our credit markets, which consists predominantly of higher rated issuers with regulated domestic-centric business models and little exposure to commodity and unintegrated energy businesses (many of which primarily issue in the high yield or US markets) reducing relative volatility.

On a sector basis, higher-rated, lower-beta issues in utilities, infrastructure, securitization and senior bank debt outperformed across the curve. The latter was supported by increased foreign funding (in lieu of domestic issuance) and Q3 earnings which were generally positive despite facing a more challenging environment (particularly those banks with a sizeable US retail presence). Conversely, lower-rated or European domiciled issuers in autos (Ford, Daimler), industrials (GE Capital, John Deere, SNC Lavalin), pipelines (Pembina Pipelines) and insurance (supply overhang) underperformed. The preference of investors to take on term risk versus credit risk was evident as the spread widening between A to BBB-rated debt increased with term.

Outlook & Strategy

We expect increased headwinds for earnings and cash flows given trade and global growth uncertainties. However, supportive monetary policy and durable credit metrics have reduced the risk of a disorderly selloff for domestic investment-grade bonds. We feel that the risks remain elevated for more speculative credit classes, such as high yield, leveraged finance and emerging markets, particularly in the event of a protracted credit downturn, given the market's fleeting risk tolerance and limited capacity to absorb riskier debt outflows. Additionally, supportive global monetary policy coordination may become problematic in a more adversarial political environment. In that vein, recent comments from Fed Chair Powell suggest there is apprehension over following a monetary policy path in the US, similar to that of either the ECB or BoJ – specifically negative rates, especially as there is little convincing theoretical or empirical evidence that negative yields will boost the trajectory of nominal growth.

Domestically, while leverage metrics remain elevated, debt servicing metrics remain healthy and even amongst the lowest rated investment grade names, refinancing risks do not appear to be a near-term threat. Similarly, domestic banks, with increased capital and provision requirements appear well positioned to navigate a deterioration in asset quality versus foreign bank and financial investors.

We feel that highly rated, liquid, short and mid-term corporates are attractive on both an absolute and relative value basis, particularly versus less defensive global credit which are vulnerable at this stage of the credit cycle. Unlike in the U.S., a profit correction should not result in widespread downgrades of BBB-rated debt to high yield as the bulk of our BBB-rated names are characterized by high leverage but stable business profiles and cash flows. With low-term premiums, we also foresee the credit curve steepening with investors being cautious to exposure of higher levered debt out the curve, particularly for those issues with limited secondary market depth.

The portfolio possesses good liquidity and is structured conservatively with a significant underweight in BBB-rated debt. It is well positioned to capitalize on relative value and yield enhancement opportunities.

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