January 31, 2019

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Investment grade credit got off to a good start as positive sentiment, supportive monetary policy and rising energy prices, overshadowed the unresolved stressors of US-China trade tensions, Brexit and the US government shutdown that have weighed on global risk assets. Domestic credit was bolstered further by foreign investor demand for Canadian issues due to Canada's relatively stable fundamental backdrop, reduced trade uncertainty, and the improved outlook for the Canadian dollar (amidst USD weakness). Domestic investment grade spreads tightened by an average of 15 bps for the month. The move can be most aptly described as aggressive as investors extended both in term and into lower rated, higher beta credit.

The momentum in the secondary market carried through to the primary market which saw $5.5 Billion of fixed-rate corporate bonds priced during the month. While issuance was below average, the renewed issuance after the hiatus late last year, reflects a marked improvement in financing conditions seen recently. Lower rated BBB issuers (Capital Power, Algonquin Power and OPG) which had intended to access the bond market in December, but had postponed due to the volatile environment, were able to price deals in January. Generally, new issues were launched with healthy concessions and were met with good demand but put pressure on spreads of the issuer in the secondary market.

For the month, short, mid and long-term corporate yield spreads tightened by 14, 17 and 14 bps respectively, resulting in absolute returns of 0.93%, 2.05% and 2.88% respectively according to the FTSE Canada All Corporate Bond Index. The outperformance of the mid-term area of the credit curve reflected the higher concentration of lower-rated BBB credit (53%) in the mid-term area versus the short (34%) and long-term (38%) areas. Absolute returns were bolstered by the bull steepening (decline in shorter-term yields) in the underlying government yield curve. For the month, underlying 2, 5, and 10 and 30-year yields fell by 9, 11, 9 and 4 bps respectively.

An increased appetite for risk was evident in sector performance as higher yielding, lower rated issues in oil and gas, pipelines and telecom broadly outperformed. Bank debt also broadly outperformed due to its traditional role as a liquid corporate proxy, the strong foreign demand for short-term senior bank debt, and reduced domestic bank supply ($3 Billion) as banks actively raised funds in foreign markets where funding costs remain relatively attractive compared with domestic levels. In contrast, higher rated, defensive issues in infrastructure, utilities and securitization broadly underperformed.

Outlook & Strategy

January provided a respite from the restrictive global financing conditions the debt market faced in recent months. As was demonstrated last quarter, the risk of a disorderly selloff is most acute for riskier credit classes, such as high yield, leveraged finance and emerging markets. The behavior of the market demonstrated that there is neither the risk tolerance nor the capacity to absorb riskier debt outflows to avoid material damage to prices and liquidity, in the event that investor sentiment shifts resulting in widespread aversion to corporate debt.

Domestically, while leverage metrics remain elevated, debt servicing metrics remain healthy and refinancing risks do not appear to be a near-term threat, even amongst the lowest rated investment grade names. 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. With low-term premiums, we also foresee investors being cautious with exposure to higher levered investment grade debt with lower ratings, 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. The portfolio is well positioned to capitalize on relative value and yield enhancement opportunities.

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