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LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Canadian credit proved to be a relatively safe harbor from the US-China trade related turmoil that beset global credit during the month. In contrast to global peers, domestic corporate spreads tightened to month-end until they succumbed to mounting pressure on risk assets as trade developments took a new twist, with Trump threatening to impose tariffs on Mexican imports unless there is a halt of illegal immigration into the US. All told, Canadian investment grade corporate spreads widened by 4 bps versus widening of 18 and 15 bps for US and global investment grade credit, respectively, and 74 bps for US high-yield credit.

The outperformance of Canadian credit was a function of Canada's fundamental sovereign strength (one of a handful rated AAA by S&P), relatively reduced trade uncertainty – the removal of US steel and aluminum tariffs (albeit later somewhat offset by the threat of US tariffs on Mexican imports), record employment numbers, and ongoing supply-demand disequilibrium. Additionally, the composition of the domestic corporate universe, with a large component of higher rated issuers with regulated domestic-centric business models and little exposure to volatile, commodity and un-integrated energy businesses (many of which primarily issue in the high yield or US markets), reduced relative volatility.

The preference of investors to take on term risk versus credit risk resulted in a bear steepening of the credit curve with short, mid and long-term corporate yield spreads widening by 2, 4 and 5 bps respectively. The negative impact of widening corporate spreads however, was more than offset by the bull flattening of the underlying government yield curve as 2, 5, 10 and 30-year yields declined by 13, 17, 22 and 22 bps respectively.

Deteriorating sentiment into month-end weighed on new issuance activity, which historically is heightened as issuers take advantage of the June 1st index extension dynamics. At $4.7 Billion issued during the month, this was the lowest fixed-rate investment grade tally for May since 2011. Similarly, south of the border, fixed-rate new issuance of US$81 Billion fell below market projections with May ending on a sour note with the average new issue concession rising to more than five times normal (3.3 bps YTD). Notably, US, high-yield issuance of US$26 Billion was the busiest since September 2017 as issuers rushed to market in the first half of May while market conditions were supportive.

On a sector basis, across the short and mid-term areas of the curve, higher-yielding issues in retail and real estate modestly outperformed whereas in the long-end, lower-beta utilities and infrastructure issues outperformed. Conversely, underperforming sectors across the curve were autos due to tariff fears, and telecom and energy due to supply pressures. Relative performance on a ratings basis reflected the cautious market stance with a bias towards higher credit quality moving out the credit curve where spread widening between AA-BBB credit became more pronounced.

Outlook & Strategy

The environment should remain favorable for domestic investment-grade bonds as supportive monetary policy and durable credit metrics have reduced the risk of a disorderly selloff. We feel however that the risks remain elevated for more speculative credit classes, such as high yield, leveraged finance and emerging markets. Given the market's risk tolerance and capacity to absorb riskier debt outflows, there is greater probability that a repricing cycle becomes self-reinforcing.

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. 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 US, a profit correction should not result in widespread downgrades of Canadian BBB-rated debt to high yield as the bulk of domestic BBB-rated names are characterized by high leverage but stable business profiles and cash flows. With low-term premiums, we also foresee investors being cautious with exposure to higher levered investment grade debt out the credit 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. The portfolio is well positioned to capitalize on relative value and yield enhancement opportunities.

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