LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Lingering European sovereign concerns and pressure from new issuance caused domestic investment grade spreads to move out an average of 4 basis points in Q4. Amidst the elevated volatility, liquidity remained strained and bid-ask spreads continued to drift wider in sympathy with the general pullback in risk.

After stalling in Q3, the primary market – buoyed by demand from the December 1st coupon payments and corresponding index extension – received $13.3B worth of investment grade issues during Q4. Although new issuance was a marked improvement from the $8.8B placed in Q3, it was still far off the pace of the $18B issued in Q4 of last year. Sizeable issuance emerged from domestic banks (five deposit note deals totaling $5.6B), pipelines (six deals totaling $1.4B) and insurance (two deals totaling $800M). Most new issues came with attractive concession yield spreads (averaging 7-15 basis points) and thus were well over-subscribed. However, few new issues were able to retain the concession levels in secondary trading. Yield spreads on issues that came with little or no concession widened very quickly in secondary activity.

For the quarter, short, mid and long-term corporate yield spreads widened by -1, 5 and 7 basis points respectively, resulting in absolute returns of 0.71%, 1.44% and 3.79% respectively according to the DEX Corporate Bond Index. The modest steepening seen in the credit curve (from wider longer term yield spreads) was driven by an imbalance in short-end demand – deposit notes and retail interest in higher beta short-term bonds, and long-end supply – non-financial firms looking to take advantage of historically low all-in yields. Demand for long-term credit continued to come from asset-liability managers.

Across the yield curve the best spread and absolute performance was reserved for telecom (no issuance), media (Yellow Media rebounding off recent lows while still included in investment grade indices), defensive sectors (gas and electric utilities) and higher quality financials (covered bonds, deposit notes and securitization). Insurance (fundamental concerns and new issuance) and power generation (acquisition of Capital Power L.P.) were the standout laggards. On a rating basis, AAA/AA rated credit generally outperformed across the curve, although BBB credit was buoyed by telecom of which all are BBB.

Portfolio Activity

Dec: Increase in weight of CU Inc. 6.8/19. Attractive sector relative value and supportive cash profile. Underweight in overall duration was reduced.

What Worked In The Quarter

The portfolio was optimally structured with a more conservative, defensive bias relative to the index. Long and mid-term issues continue to be concentrated in defensive sectors such as regulated utilities, pipelines and infrastructure issuers with unfettered rate setting ability. The higher beta issues that are held are shorter-term.

On both a market weighted and duration weighted basis, the portfolio was significantly underweight insurance and financials.

What Didn't Work In The Quarter

In anticipation of yield spread widening opportunities, the portfolio's overall duration was held an average of 18 basis points of a year shorter than that of the index. Although corporate spreads widened significantly, this was more than offset by the fall in underlying government yields (32 basis points) during November and December.

Outlook & Strategy

We believe that the corporate bond market will continue to be impacted more by exogenous events and supply, than a significant degradation in the general quality of credits. Increasing risk premiums and a volatile macroeconomic backdrop provide little catalyst for significant spread tightening, and hence we are not yet ready to move from our defensive bias. However, with the potential for increased volatility and event risk, there will continue to be opportunities to capitalize from relative value and yield enhancement trades.

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