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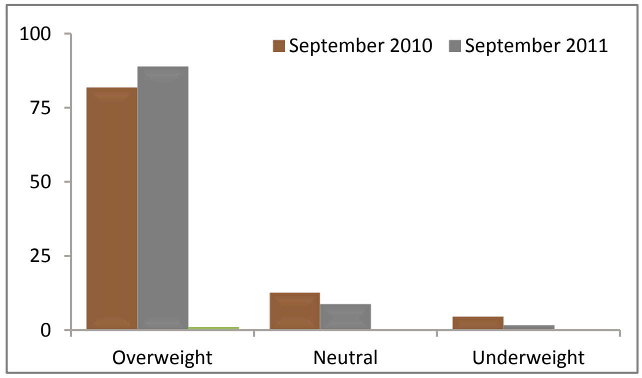
What We Think……

Rarely do we find ourselves in a situation with so much to talk about that we find it difficult to figure out where to start. In turbulent times, there are no shortage of angles to seek and correspondingly no shortage of sides to take. While we find the frequency of emerging events and the diversity of analysis and opinion engaging, the unpredictability has been somewhat disconcerting. However, we remind ourselves that we are retained principally as bond managers and not political commentators (although at present we sometimes feel more the latter). So, for this commentary we have decided to focus squarely on the on the bond market, paying particular attention to Canadian corporate bonds.

It is not surprising that with level of uncertainty and likewise volatility so high, investors tend to stand back and wait for a consensus to emerge before acting. As a result, many markets, including the Canadian corporate bond market, have been plagued with poor liquidity as investors have chosen, or in many cases have been forced, to stand on the sidelines as spectators. Contrast this with the environment a year ago when the majority of investors were all pointing in the same direction, embracing risk assets of all types, and consequently active in the markets. In Canada, corporate bonds were in great demand and investors were willing to take on corporate bond exposure, and in many cases as much as their mandates would permit. (See figure 1.)

During the 2008-2009 collapse of global credit markets, yield spreads widened indiscriminately across all sectors. At that time, U.S. Treasuries were the risk-free asset of choice and all yield spreads widened against them, irrespective of credit quality and credit rating. What emerged was both a severe credit crisis and an unprecedented liquidity crisis – intermediaries were unwilling to take on positions beyond the highest quality government bonds.

Figure 1: Canadian Institutional Investors Corporate Position

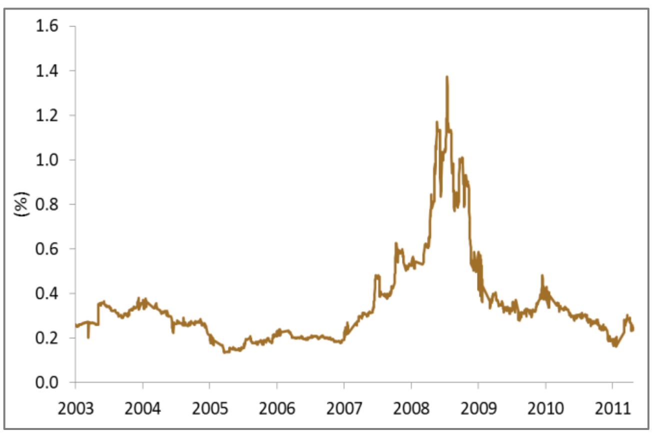


Source: TD Securities, Debt Capital Markets

We recall that Government of Canada bonds underperformed Treasuries as the Canada-U.S. 10-year yield spread widened from 45 basis points thru in August '08 to 71 bps over by December. While government of Canada bonds were not the global safe-haven offered by U.S. Treasuries, they were the safe-haven in a Canadian context. Yield spreads across all sectors widened against Government of Canada's irrespective of credit quality. For instance 5-year Canadian Mortgage Bonds (a triple AAA credit guaranteed by CMHC and backed by the Government of Canada) reached a peak yield spread of 137 basis points, as compared to around 20 bps prior to the crisis. (See figure 2.) Although the widening of yield spreads was more severe in weaker credits, higher rated debt offered little protection through the crisis. (See figure 3.)

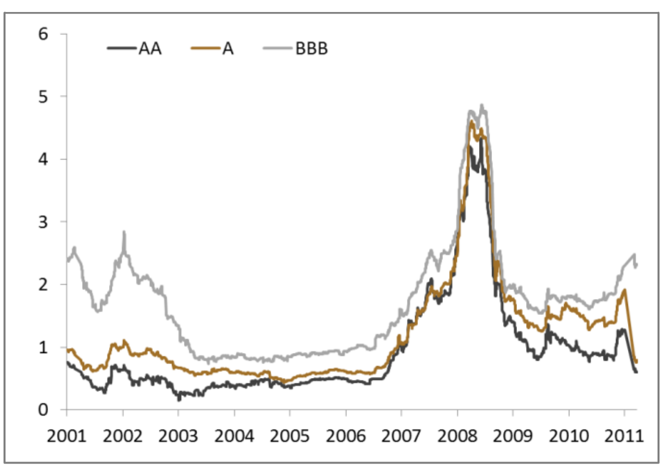
Back in 2008, the scope for political and monetary authority response to the credit crisis was significant. The U.S. Treasury department and the Fed took a leading role in responding to the crisis with a series of responses that were designed to backstop the financial system and create investor confidence. The G-20 governments and central banks were not far behind with co-ordinated responses. As a result there was a gradual resumption of market activity (there seems to always be a lot more activity on the way up than on the way down) and in the credit markets yield spreads began a gradual reversal that lasted until the summer of 2010.

Figure 2: Canada Mortgage Bond vs Government of Canada Yield Spread
(CMHC 4 5/8% June 3, 2013 vs Canada 5 ¼% June 1, 2013)



Source: Lorica Investment Counsel Inc. & PC-Bond, September 2011

Figure 3: DEX Mid-Term Corporate Yield Spreads

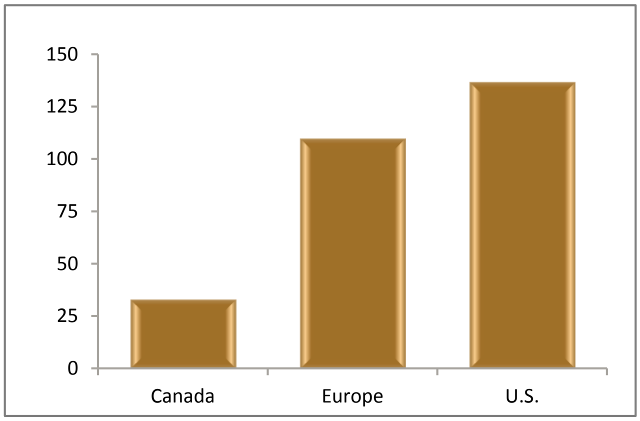


Source: Lorica Investment Counsel Inc. & PC-Bond, September 2011

However, credit markets were again unnerved in 2010 as the European sovereign crisis percolated to the service and developed country growth began to falter. Investors again went into retreat from risk assets; however authorities were quick to respond preventing another credit and possibly liquidity crisis from taking hold. Yield spreads, which had widened, quickly reversed in like fashion following Fed chairman Bernanke's reference, at the Jackson Hole (Wyoming) symposium, to a second round of quantitative easing. The EU's subsequent backstop of Greece further calmed matters and subsequently risk assets, including corporate bonds, rallied into year-end. Instructively, the yield spread widening in the summer was very different from the year before – investors were far more discerning, mainly discounting credits on the basis of quality rather than liquidity or potential illiquidity.

This year's bout of credit spread widening has been gradual as it has taken time for investors to accept that the outlook for economic recovery has been far too optimistic (there still seems to be too much denial surrounding the outlook for the European sovereign debt crisis). The consensus from the January Bloomberg survey of economic forecasters was for reasonable U.S. recovery in 2011 with the median forecast for GDP growth at 3.1%; that has now been ratcheted down to a disappointing 1.6% for 2011. Confidence in risk assets, most notably in financial stocks and bonds, has steadily eroded as investors have become more sensitive to the prospect of contagion from the European debt crisis. In corporate bond markets, European and U.S. banks have been hit the hardest, while Canadian banks have been spared much of the blood-letting, consistent with investors enamour of all things Canadian. (See figure 4.)

Figure 4: Q3 Senior Bank Debt Yield Spread Widening



Source: Lorica Investment Counsel, PC-Bond & Bank of America, September 2011

In general, this go-round of spread widening has been far less evident in Canada than in other developed countries (same can be said of Australia). We suggest several explanations including:

i. The relative closed nature of the Canadian corporate market which consigns most of the issuance to Canadian investors thereby limiting some of the transmission of spread change from other jurisdictions. The 2008-9 liquidity crisis was an anomaly as no credit was spared.

ii. Canada's healthier fiscal and economic situation relative to many of the other developed countries has resulted in both stock and corporate bond outperformance.

iii. The superior state of Canadian Financials due to relatively few bad loans and the reliance primarily on deposit financing.

iv. The homogeneity of liquidity providers in Canada – i.e. the schedule A banks, which historically has resulted in a decoupling of Canadian yield spreads from those in other developed markets. (Financials represent 49% of the Canadian corporate bond market.)

Never-the-less, the Canadian DEX mid-term corporate yield spreads have widened since February by an average of 50, 60 and 70 bps for AA, A and BBB respectively. In contrast, U.S. INDEX yield spreads have widened by 104, 123, and 131 bps for AA, A and BBB over the same period.

Although Canadian corporates have been more resilient than elsewhere, we feel that the Canadian marketplace has not been entirely tested this go-round. In 2008-9, the illiquidity in the marketplace was pervasive and driven from a real fear of counterparty risks that could potentially undermine the whole financial system, and at the very least individual corporations. Investors felt that they could not trust bank balance sheets to tell the whole story. For a time, there was also the uncertainty of support from fiscal and monetary authorities. In any event, Canadian corporate yield spreads reflected the absence of buyers and some forced sellers.

Today, the illiquidity in the market place is of an entirely different sort. There is not the same number of motivated sellers forcing yield spreads higher; instead bid-offer spreads have widened enough to deter most investors, who bulked up on credit in the last couple of years, from selling. Also not to be underestimated is a much more modest level of investor fear – after all most credit investors survived 2008-9 by staying the course; spreads eventually rebounded and holders were rewarded for their patience.

The amount of protection embedded in corporate yields has increased significantly since the beginning of the year. For example, the average one-year break-even yield spread for a mid-term corporate is now 23 (AA), 32 (A) and 37 (BBB) basis points implying that yield spreads would have to widen to 150, 220 and 266 for AA, A and BBB respectively over a 12-month period to move

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Figure 5: Canadian Corporate Yield Spreads During Recessions - The Last 30 Years

Recession (Can/US)		1981 1982	1990 1991	2001*	2008 2009*	
Peak		Mar 1982	Feb 1993	Oct 2002	Mar 2009	Sep 2011
DEX Mid Index Yield Spread	AA	172	90	71	423	110
	A	214	201	109	450	172
	BBB	233	527	283	477	212

*U.S. Only

Source: Lorica Investment Counsel & PC-Bond, September 2011

corporate investments offside relative to Government of Canada's. We have prepared a table of Canadian corporate yield spreads during recessions over the last 30 years (See figure 5). On a comparative basis yield spreads likely have room to widen from current levels in the event of a recession. However, given the health of corporate balance sheets we would expect spreads to behave relatively better than in previous recessions. Furthermore, we don't foresee the impetuous liquidity driven widening of three years ago.

We have commented elsewhere that we expect the global economy to fall into recession late this year or early next, and expect the Canadian economy to follow suit, albeit with a lag. We anticipate that the Canadian corporate market will remain orderly, even in the event of a Greek default, other European sovereign debt problems or recession in the U.S. and Canada. But we do not anticipate liquidity to improve significantly. Our portfolios have been more defensively positioned towards corporate credit from the beginning of the year, however despite the wider break-even's we will still wait to increase corporate exposure.

Of course the risk still remains that the Eurozone drastically implodes from the weight of its sovereign debt issues, which reach a point when they can no longer be postponed. However, we suspect that whatever the end game in Europe is, it will not derail the credit markets in Canada. We see the likelihood of another credit driven liquidity event here, similar to '08, as being relatively small.

Break-even Yield Spread Change

We define the break-even yield spread change as the change from the current yield spread of a corporate (or any other non-government of Canada) bond versus a similar duration government of Canada bond over one year that will result in the corporate (or other non-government of Canada) bond having the same performance as the government of Canada bond.

Y_C^t: *Yield on government of Canada at time t*

Y_x^t: *Yield on corporate bond x at time t*

MD_x: *Modified Duration of bond x*

Break-Even Yield Spread Change for bond x

$$\cong \frac{Y_x^t - Y_C^t}{MD_x}$$