LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Investors in the Canadian corporate debt market adopted a cautious tone in Q1 in response to a mixed global macro backdrop, weak commodity prices, and an unexpected rate cut from the Bank of Canada which gave credence to a "weakening domestic economy" view. Corporate spreads were relatively unchanged, widening by a basis point, on average, during the quarter, with investors slightly biased towards reduced exposure to higher beta credit out the credit curve and the credit spectrum.

For the quarter, short corporate yield spreads widened by 4 bps whereas mid and long-term corporate yield spreads tightened by 1 bp, resulting in absolute returns of 2.05%, 4.23% and 6.27% respectively, according to the FTSE TMX Canada All Corporate Bond Index. On an absolute basis, overall returns were predominately driven by the bull steepening of the underlying government yield curve.

The cautious market tone was evident in sector performance with lower-rated, higher yielding issues in the energy and retail sector outperforming in the short-term area of the credit curve; and more defensive, higher rated issues in utilities and infrastructure outperforming in the mid and long-term area of the credit curve. The outperformance became more pronounced as one moved out the credit curve, as the widening basis from A to BBB increased with term.

Domestically, oil price fluctuations continued to dominate credit headlines. In the Canadian high yield space (where energy comprises 40 percent of the FTSE TMX High Yield Index) spreads gapped out by 38 basis points on average, and no new issues were floated in the quarter. In contrast, the domestic investment grade energy space benefitted from stabilizing oil prices and positive comments from S&P highlighting the sector's capital spending flexibility, low leverage and liquidity. During the quarter, spreads in the investment grade oil sector tightened by an average of 4 basis points. Spreads would have narrowed further however a large 10 year issue from Husky Energy acted as a headwind.

From a tepid start in January, primary issuance ramped up to total $26.1 billion for the quarter. Issuance was dominated by the banks ($13.8 billion) and telecom ($2.2 billion) with the former including BNS's first Basel III compliant non-viability contingent capital (NVCC) subordinated debt issue and the latter driven by funding of the AWS-3 wireless spectrum auction. Generally, issuers were aggressive in locking in historically low all-in borrowing costs as evident by the weighted average term-to-maturity of new debt of 8.3 years (versus 7.1 years over the same period the last three years), and the high percentage of BBB issuance (70% of non-financial issuance).

Portfolio Activity

On the back of supply pressures, the portfolio opportunistically reduced its underweight (on a duration basis) in financials via an increase of senior bank debt and a corresponding reduction in short-dated bank sub debt (< 1 year) and municipals (profit taking on relative outperformance). Longer dated senior bank debt should benefit from the expected bail-in capital legislation for domestic systemically important banks (D-SIB) to be passed later this year.

What Worked In The Quarter

The portfolio benefitted from optimal sector distribution, holding shorter-term higher yielding corporates as a source of alpha, and mid and long-term outperforming higher rated issues with more defensive characteristics such as utilities.

What Didn't Work In The Quarter

Relative to the index, the portfolio is more conservatively structured with a shorter duration and an overweight in the belly (5-7 year) of the yield curve in lieu of long bonds. For the quarter, 2, 5, 10 and 30-year Canada's fell by 50, 63, 54 and 35 basis points respectively.

Outlook & Strategy

From the perspective of corporate fundamentals, we feel that we have surpassed the credit cycle peak however in the short-term we do not expect any significant degradation in credit metrics. Low energy prices remain a concern on both a macro and micro level however we feel that, in the medium-term, any direct and indirect adverse impact on investment grade credit will be mitigated by strong credit profiles and limited concentration and counterparty risk.

Corporate spread levels currently represent more than half of all-in-yields (very high end of post-credit crisis range) and thus provide good relative value. The portfolio is structured conservatively and possesses good credit liquidity, and is therefore, well positioned to capitalize on relative value and yield enhancement opportunities.

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