LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

The corporate bond market deteriorated into quarter-end, after a benign start to Q2, as "*Grexit*" concerns, reduced liquidity, weak domestic economic data and a focus on new issuance in lieu of secondary markets weighed on credit spreads. All told, domestic corporate spreads widened by an average of 9 basis points for the quarter. While investors continued to focus on shorter term corporates as a source of alpha, there was increased hesitation (beyond long-term asset liability managers) to extend into longer duration credit with the prospect of higher underlying government yields on the horizon and increased risk aversion.

Short, mid and long-term corporate yield spreads widened by 8, 8 and 10 basis points respectively for the quarter, resulting in absolute returns of 0.31%, -1.09% and -4.73% respectively according to the FTSE TMX Canada All Corporate Bond Index. The steepening of the credit curve highlighted pressure associated with an uptick in primary activity late in the quarter and waning demand for duration and long credit risk (particularly riskier issues). Weakness in utilities and pipelines (electricity/gas distributors and pipelines make up half of long corporates) also weighed on mid and long-term credit spreads. On an absolute basis, overall returns were predominately driven by the steepening of the underlying government yield curve. For the quarter, underlying 2, 5, 10 and 30 year government yields rose by 0, 4, 32 and 32 basis points respectively.

On a sector basis, the best spread and absolute performance across the yield curve was reserved for higher rated, lower risk, liquid issues in insurance and senior/legacy subordinated bank debt as investors cautiously reached for yield (as a source of added value). Alternatively, real estate, telecom and lower rated utilities/pipelines underperformed due to supply overhang, lingering regulatory concerns and rating downgrades. On a rating basis, performance between rating classes was similar in the short-term area of the credit curve however AA rated credit outperformed in the mid and long-term as the widening spread between AA-BBB was positively correlated with term.

After a slow start, the prospect of higher yields encouraged issuers to come to market with increasingly aggressive deals in terms of size, tenure and credit quality. In total, $21.3 billion was priced during Q2 with significant issuance emerging from the domestic banks ($6 billion), autos ($2.4 billion), foreign banks ($2 billion) and real estate ($1.7 billion). Generally, new issues came to market with healthy concessions and were met with good demand. However, secondary spreads of outstanding issues (particularly for lower-rated issuers) subsequently widened out to the clearing levels of the new deals.

Portfolio Activity

On the back of supply pressure, the steepening of the credit curve and volatility in the spread between senior deposit notes and legacy subordinated debt, the portfolio opportunistically increased exposure (on a duration basis) to financials via an increase in senior bank debt and a reduction in short-dated bank sub debt.

What Worked In The Quarter

Relative to the index, the portfolio is conservatively structured with a shorter duration and an overweight in the belly (5 year) of the yield curve in lieu of long bonds. For the quarter, the credit curve shifted wider and the underlying government yield curve steepened significantly. Additionally, the portfolio's sector distribution benefitted from an overweight in shorter-term higher yielding insurance and bank debt (as a source of added value).

What Didn't Work In The Quarter

The portfolio was overweight telecom and cable issuers relative to the index which marginally underperformed relative to other sectors.

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. We do feel that the prospect of higher rates has the potential to mitigate corporate returns through asset class rotation, reduced liquidity and aggressive issuance activity. In this environment we foresee investors continuing to be cautious with exposure to higher risk credit out the credit curve.

Corporate spread levels currently represent nearly half of all-in-yields and thus provide good relative value. The portfolio is structured conservatively, possesses good liquidity, and therefore is well positioned to capitalize on relative value and yield enhancement opportunities.

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