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LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

The corporate bond market deteriorated into year-end as the rout in commodity prices, waning investor appetite and ongoing constrained liquidity weighed on credit spreads. For the quarter, domestic corporate spreads widened by an average of 7 bps (according to the FTSE TMX Canada All Corporate Bond Index), bringing the widening tally to 42 bps for the year, with increased aversion to issues further out the credit curve and the credit spectrum. Generally, the movement of domestic credit spreads continues to be largely driven more by macro factors than by micro trends.

For the quarter, short, mid and long-term corporate yield spreads widened by 6, 7 and 9 bps respectively, resulting in absolute returns of 0.62%, 0.63% and 0.63% respectively according to the Corporate Index. The modest steepening of the credit curve reflected a bias to reduce duration exposure to credit. On an absolute basis, the yield pick-up coupled with the rally in underlying government yields compensated for the widening of credit spreads. For the quarter, 2-30 year government yields fell between 5-8 bps.

Across the yield curve the best spread and absolute performance was reserved for: auto finance – strong auto sales and retracement of prior VW related spread widening; infrastructure – low beta; senior and legacy subordinated bank debt – reduced issuance; telecom and cable (Shaw being the notable exception) – solid earnings reports and BCE deleveraging; and retail – no issuance. The worst performance came from: lower rated issues in power generation – TransAlta and Capital Power; energy related issuers – producers and pipelines; and bank hybrid debt – supply pressures and pricing concerns.

The outperformance became more pronounced as one moved out the credit curve as the widening basis between AA-BBB was positively correlated with term. As a result, performance between rating classes was similar in the short-term area of the credit curve where the higher yield of lower-rated issues offset greater spread widening. While, in the mid and long-term, non-energy related A & AA-rated credit outperformed BBB-rated issues that did not have sufficient yield protection against spread widening.

With reduced risk appetite, primary market issuance of $13.2 billion was down from the $14.2 and $21.3 billion priced in Q4 of 2014 and 2013 respectively. Generally, new issues came with material concessions and most were subsequently met with healthy demand, however as a consequence of reduced liquidity, few performed well in secondary trading. Significant issuance emerged from routine issuers in the domestic bank ($6.5 billion), insurance ($1 billion) and telecom ($1 billion) space.

Portfolio Activity

On the back of widening credit spreads, the portfolio opportunistically increased exposure to higher yielding short-term, higher beta debt in insurance and autos, via a reduction in short-term utilities, trading at a premium. The portfolio's duration and yield curve bias was maintained.

What Worked In The Quarter

The portfolio's sector distribution was positive for performance, benefitting from the concentration in higher yielding short-term debt (as a source of alpha) in sectors which were top performers, i.e. municipals, senior and subordinated legacy bank issues, telecom/cable and autos. Portfolio performance was also aided by the modest steepening of the credit curve.

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 5-year area of the yield curve in lieu of longer term bonds.

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. In the near term corporate spreads should remain under pressure due to ongoing reduced liquidity and volatile equity markets. In this environment we foresee investors continuing to be cautious with exposure to higher beta credit out the credit curve.

The drop in energy prices remains a headwind 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. The negative economic outlook may spark reviews of corporate spending and borrowing plans, which could diminish expectations for new issuance from Canadian corporates.

Corporate spread levels currently represent over 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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