March 31, 2016

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Through much of the quarter, risk off sentiment prevailed over Canadian credit due to plummeting energy prices, Chinese growth concerns, headwinds from concessionary issuance and deteriorating credit quality. Some reprieve came at the back-half of the quarter, due to a bounce in oil prices and supportive central bank actions. The latter, which included Chair Yellen's "dovish" sentiments, the ECB's expansion of quantitative easing into corporates, and the Bank of Japan's February drop to negative interest rates, coerced international investors to hunt for yield. With a rallying loonie acting as a beacon, the Canadian corporate market benefited from a significant, albeit temporary, uptick in international inflows causing domestic corporate spreads to retrace much of their earlier widening, closing wider on the quarter by only an average of 2 basis points.

For the quarter, mid-term corporate yield spreads rose by 7 bps while short and long-term spreads were flat, resulting in absolute returns of 0.60%, 1.69% and 3.34% respectively according to the FTSE TMX Canada All Corporate Bond Index. The short-term area of the credit curve benefitted from the concentration of bank deposit notes in this term whereas the long-end benefitted from a concentration in utilities. Absolute returns were bolstered by the rally in the underlying Government of Canada yield curve. For the quarter 2-year Canada yields rose by 6 bps and 5, 10 and 30 year yields fell by 16, 17 and 14 bps respectively.

Across the yield curve, the best spread and absolute performance was reserved for lower-beta, higher-rated issues in utilities, senior bank debt (aided by foreign buying) and telecom (Shaw's media divesture allayed supply and credit rating downgrade fears, while Rogers skipped a dividend increase to focus on debt reduction). Alternatively, oil and gas producers and bank hybrid Tier 1 debt (issuance pressures and lagging concerns over European bank hybrids) underperformed. Relative performance reflected sector moves: AA-rated (senior bank) debt generally outperformed in the short and mid-term areas whereas lower-beta, BBB-rated (telecom) debt outperformed in the long-end.

Given the environment replete with elevated intra-day volatility and the presence of attractive funding levels in other markets (international, direct bank financing), primary market issuance of $18.5 billion was down from the $26.1 and $21.6 billion of Q1 of 2015 and 2014 respectively. Despite sizeable concessions, new deals generally were unable to retrace concessionary pricing discount, putting acute pressure on secondary levels of similar issues. Significant issuance emerged from routine issuers in the domestic bank ($9.8 billion), autos ($1.6 billion) and insurance ($1 billion).

Portfolio Activity

On the back of supply pressure, we took the opportunity to increase exposure to short-term, higher-yielding subordinated insurance debt. The portfolio's duration and yield curve biases were maintained.

What Worked In The Quarter

The portfolio benefitted from its sector distribution with its concentration in shorter-term, higher yielding debt (as a source of alpha) in sectors which were top performers – telecom & cable, senior bank debt, securitization and autos.

What Didn't Work In The Quarter

The portfolio was conservatively structured with a shorter-duration than the index and an overweight in the 5-year area of the yield curve in lieu of long bonds.

Outlook & Strategy

From the perspective of corporate fundamentals, we have surpassed the credit cycle peak. The continuing degradation in credit metrics coupled with the growth of lower-rated debt (BBB-rated debt now accounts as the largest rating class) has made the domestic corporate market more sensitive to global event risk. We feel that, in the near term, there is an increased risk that corporate spreads will come under pressure as they are currently buoyed by international demand which may be fleeting. Also, 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 of investment grade credit will be mitigated by strong credit profiles and limited concentration and counterparty risk.

In this environment we foresee investors being cautious with exposure to higher beta credit out the credit curve, particularly for those issues with limited secondary market depth or a penchant for shareholder friendly initiatives. Corporate spread levels currently represent over sixty percent of all-in-yields and thus provide good relative value. The portfolio is structured conservatively, possesses good liquidity, and is therefore well positioned to capitalize on relative value and yield enhancement opportunities.

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