June 30, 2016

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Exogenous factors overshadowed deteriorating corporate fundamentals in the Canadian corporate market during Q2. Early in the quarter, this manifested itself as an aggressive rally, as supportive monetary policy and rising commodity prices, lured both domestic and foreign investors to reach for yield via increased exposure to longer dated, lower rated Canadian credit. Credit markets were further buoyed by reduced primary issuance, as issuers took advantage of relatively attractive funding levels in international markets. In the latter part of the quarter however, once Brexit emerged as a more tangible concern and secondary market liquidity fluctuated, credit spreads see-sawed, first widening, then rebounding into the vote and finally gapping wider by 10-12 bps on the unexpected result. All told, domestic credit spreads tightened on the quarter by an average 7 bps.

For the quarter, short, mid and long-term corporate yield spreads tightened by 10, 9 and 3 bps respectively, resulting in absolute returns of 1.01%, 2.97% and 5.17% respectively according to the FTSE TMX Canada All Corporate Bond Index. The bull steepening of the credit curve reflected risk-off sentiment late in the quarter, which resulted in liquid provincials being the preferred means to get credit exposure in the Canadian long-end. Absolute returns were bolstered by the bull flattening of the underlying government yield curve. For the quarter underlying 2, 5, 10 and 30 year yields fell by 2, 11 and 26 and 29 bps respectively.

Across the yield curve, the best spread and absolute performance was reserved for higher yielding, lower rated issuers in energy exploration (rebound in oil prices and the impact from Fort McMurray fire viewed as temporary), pipelines (positive earnings), energy generation (rebound of prior widening), auto finance and insurance. Alternatively, selling pressure into quarter-end resulted in underperformance of issuers with a greater depth for bids, i.e. higher-rated infrastructure and utilities, lower-rated telecom. Relative performance on a ratings basis reflected the sector moves as lower rated debt outperformed across the credit curve.

Despite low all-in borrowing costs and demand stemming from the June 1st technical bid – a combination of large coupon payments and index extension, only $18 Billion of new fixed-rate deals came to market, the lowest tally for Q2 in five years. In stark contrast, investment grade issuance south of the border neared a record for Q2. The softness in Canadian primary issuance can be partially attributed to the uptick in domestic issuers, particularly the banks, opportunistically tapping foreign markets. Notably, domestic banks have significantly increased European issuance this year over last, as they vie to reap the benefits of low rates and the ECB's recently launched corporate QE program. Significant issuance emerged from banks ($7.6 Billion in deposit notes, covered and NVCC), pipelines ($1.4 Billion) and autos ($1.1 Billion).

Portfolio Activity

On the back of supply pressure and periods of market weakness, the portfolio opportunistically increased exposure to higher-yielding insurance, pipelines and subordinated bank debt. The portfolio's duration and yield curve bias were maintained.

What Worked In The Quarter

Performance benefitted from the sector distribution with a concentration in shorter-term, higher yielding debt (as a source of alpha) in top performing sectors: pipelines, insurance and auto debt.

What Didn't Work In The Quarter

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

Outlook & Strategy

The continuing deterioration in credit metrics coupled with the growth of BBB-rated debt has made the domestic corporate market more sensitive to global event risks. We feel that in the near term there is increased risk that corporate spreads will come under pressure as they are currently buoyed by supply/demand imbalances stemming from a reach for yield and fleeting international flows. Low energy prices remain a concern on both macro and micro levels, but we feel that any direct and indirect adverse impact on 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. 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 therefore is well positioned to capitalize on relative value and yield enhancement opportunities.

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