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LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Canadian corporate bond returns in Q4 were mainly driven by events south of the border. Event risk leading up to the American presidential election resulted in heightened volatility (VIX neared Brexit-highs), falling yields, and sparse new issuance. The Trump victory triggered a global bear steepening in sovereign yield curves immediately following the election, amidst expectations of stimulus and reduced regulatory policies that suggest an increase to economic growth, the deficit and inflation. The Federal Reserve consolidated the uptrend in bond yields by raising rates for the second time since the credit crisis and also raising its expected tightening path. With global risk assets rallying and corporate bonds providing a degree of breakeven protection for rising bond yields, domestic credit spreads tightened by an average of 19 bps during the quarter.

Short, mid and long-term corporate yield spreads tightened by 17, 20 and 20 bps respectively over the quarter. This parallel narrowing of the credit curve relative to government bonds was reflective of the broad-based risk-on market sentiment. Tighter spreads were, however, unable to completely offset the bear steepening effect of the underlying government yield curve as Canada 2, 5, 10 and 30 year yields rose by 24, 50, 71 and 65 bps respectively. Q4 total returns were –0.13%, –1.89% and –5.12% for the Short, Mid and Long Term FTSE TMX Canada All Corporate Bond Indices, respectively.

Across the yield curve, the best spread and absolute performance was reserved for sectors positively impacted by rising interest rates and a steeper yield curve: insurance and subordinated bank debt; higher yielding issues in energy exploration and pipelines due to the stabilization in oil prices; and lower-rated energy generation issuers given the increased clarity of the Alberta Power market. Alternatively, less liquid issues underperformed including: real estate facing headwinds from rising interest rates; Teranet in the industrial service sector; grocer Sobeys (retail) who was downgraded to junk by S&P; and infrastructure where the government announced a review of airport privatization. Relative performance across ratings reflected a strong appetite for risk as lower-rated debt outperformed across the curve, however, with the degree of outperformance decreasing with the increase in term.

The pace of Canadian corporate issuance was slow to start the quarter due to underlying rate volatility and jitters over the US presidential election which was weighing on market sentiment. However, postelection, jumbo issuance emerged from domestic and foreign banks – a combined $10 Billion for the quarter, resulting in a healthy $17.7 Billion being issued by corporations during Q4.

Portfolio Activity

On the back of yield curve bear steepening, the portfolio increased exposure to higher-yielding senior and subordinated bank debt and reduced exposure to subordinated insurance debt. The portfolio's duration and yield curve bias were maintained.

What Worked 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 – long term corporate yields rose by 45 bps. The portfolio also benefitted from its sector exposure distribution as it was overweight in pipelines, telecom, insurance and subordinated bank debt which were all top performers. The portfolio had no exposure to real estate, retail and airport issuers which were underperformers.

What Didn't Work In The Quarter

The portfolio lacked exposure to lower-rated energy generation issuers such as TransAlta and Capital Power which outperformed for the quarter.

Outlook & Strategy

Eroding credit metrics coupled with the growth of the BBB-rated debt class has made the domestic corporate market more sensitive to global event risk. We feel that in the near term there is increased risk that corporate spreads will be pressured as they are currently buoyed by a demand/supply imbalance that with the prospect of higher interest rates on the horizon may be fleeting.

We foresee investors being cautious with exposure to higher levered debt out the credit curve, particularly for those issues with limited secondary market depth. Corporate spread levels currently represent almost half of all-in-yields and thus provide good relative value, particularly in shorter maturities. The portfolio possesses good liquidity and is structured conservatively with minimal exposure to sectors or issuers that would be negatively impacted in the event of higher interest rates. It is also well positioned to capitalize on relative value and yield enhancement opportunities.

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