LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

With the Trump transition in focus, corporate bond markets rallied through February on cues that the Trump administration would bring forth a significant economic stimulus program. Canadian credit markets further benefitted from positive economic data, a dearth of primary issuance and an uptick in international inflows – the result of foreign investors global search for attractive yielding, high-grade debt. The rally stalled in March however, as political wrangling in Washington and heavy domestic issuance weighed on investor sentiment.

All told, domestic credit spreads tightened by an average of 13 basis points during the quarter, with short, mid and long-term corporate yield spreads tightening by 14, 12 and 14 bps respectively. Absolute returns were bolstered by the drop in the underlying government yield curve as Canada 2, 5, 10 and 30 year yields fell by 2, 8, 9, and 0 bps respectively. This resulted in absolute returns of 1.09%, 2.28% and 3.06% for the short, mid and long-term FTSE TMX Canada All Corporate Bond Indices, respectively. The parallel shift tighter of the credit curve relative to government bonds was reflective of the market sentiment shift towards risk-on that took hold during the quarter.

Across the yield curve, the best spread and absolute performance was reserved for lower-rated (BBB-), higher beta debt in energy generation and retail (Sobey's). Higher yielding issues of insurance, media and subordinated bank debt also broadly outperformed. In contrast, defensive, higher-rated issuers from the infrastructure and utilities space lagged. On a rating basis, risk-on sentiment was evident as higher-yielding, lower-rated debt generally outperformed across the credit curve.

After the primary market's underwhelming start to the year, momentum from the secondary market finally migrated to the primary market, resulting in the issuance of $21.6 Billion of fixed-rate corporate bonds. With domestic banks active abroad and an investor predilection for higher beta corporate issuers, BBB issuers across a number of sectors (energy, real estate, retail, pipelines and telecom) exploited the window of opportunity to launch new issues. Overall, BBB-rated issuance accounted for 39% of all primary issuance in Q1 compared to the 25% share for calendar year 2016.

Portfolio Activity

With the credit curve flattening, the opportunity was taken to decrease exposure to longer-term credit with a corresponding increase of exposure to mid-term energy debt, providing a relatively higher degree of breakeven protection for rising bond yields. The portfolio's duration, yield curve and credit quality bias were maintained.

What Worked In The Quarter

The corporate exposure of the portfolio was concentrated in shorter-dated, higher yielding issues in top performing sectors: insurance, autos and subordinated bank debt. The portfolio was underweight infrastructure and utility issuers which lagged. On a duration-weighted basis, corporate spreads in the portfolio narrowed by 20 bps over the quarter.

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. Long-term corporate yields fell by 15 bps. The portfolio also lacked exposure to lower-rated issuers in energy generation and retail which outperformed.

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, near-term, there is increased risk that corporate spreads will come under pressure, given they are currently buoyed by a supply/demand imbalance, which may be fleeting, especially considering the prospect for higher interest rates. We have already seen hints of the vulnerability of corporate bond prices: e.g. US high yield spreads widened by 40 bps from their early March lows on the back of significant fund outflows and heavy issuance.

In the current environment, we foresee investor caution vis-à-vis exposure to higher levered debt out the credit curve, particularly for those issues with limited secondary market depth. However, corporate spread levels, which currently represent almost half of all-in yields, still provide good relative value. The portfolio possesses good liquidity, is structured conservatively with minimal exposure to sectors or issuers that would be negatively impacted in the event of higher interest rates, and is well positioned to capitalize on relative value and yield enhancement opportunities.

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