LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Canadian credit markets rallied through the first half of Q2 in response to the dearth of new issuance, supportive French election results and few signs of systemic risk resulting from Home Capital's woes. Sentiment soured, however, following Moody's downgrade of the Canadian banks in May, weakening of energy prices, escalating geopolitical concerns and record new issuance (led by a deluge of foreign and lower-rated issuers). Finally, announcements in June by various central banks that tighter monetary policy was on the horizon were the largest driver of corporate returns during the quarter. Given the degree of breakeven protection for rising yields provided by corporate bonds, domestic credit spreads tightened significantly on the central bank news.

Collectively, corporate spreads narrowed by an average of 3 basis points over the quarter, with short, mid and long-term yield spreads narrowing by 2, 1 and 7 bps respectively. The bull flattening of the yield spread curve was a reaction to the flattening of the underlying Government of Canada yield curve as long bond investors cautiously sought higher-rated corporates in a pursuit for yield. During the quarter, Canada 2, 5 and 10 year yields rose by 31, 26 and 3 bps respectively, whereas 30 year yields fell by 18 bps. This move dampened returns for the FTSE Russell Corporate Short and Mid Indices (-0.27% and 0.14% respectively) and bolstered the return for the Long Corporate Index (4.34%).

The real estate sector was under continued pressure during the quarter, first from concerns over Home Capital's funding and later from worries over Crombie and Cominar REITs being downgraded to junk, and Granite REIT's activist investor actions. However, contagion was limited to mortgage lenders and real estate issuers. Oil & gas and pipeline issues also came under pressure due to falling energy prices and new issuance overhang.

Across the yield curve, the best spread and absolute performance was reserved for higher yielding telecom and cable debt, NVCC subordinated bank debt (following the announcement of index inclusion) and defensive utility issues.

On a ratings basis, relative outperformance generally became more pronounced as one moved out the credit curve, as the spread narrowing between BBB's and AA's decreased with increasing term. Consequently, higher-yielding, lower-rated debt outperformed in the short-term area of the yield curve, A-rated debt outperformed in the mid-term area, while AA-rated debt outperformed in the long-term.

Portfolio Activity

On the back of new issuance supply pressures, we reduced the portfolio's exposure to longer-term credit and increased exposure to shorter-term financial debt, providing a relative higher degree of breakeven protection for rising bond yields. The portfolio's overall duration 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 sectors which were top performers: telecom, subordinated bank debt and insurance. The portfolio had no exposure to real estate issuers or mortgage lenders. On a duration-weighted basis, corporate spreads in the portfolio narrowed by 6 bps over the quarter.

What Did Not 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 25 bps and the corporate yield curve (2-30's) flattened by 54 bps.

Outlook & Strategy

Elevated 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 also feel that, near-term, there is an increased risk that corporate spreads will be pressured as they are currently buoyed by a supply/demand imbalance, which, with the prospect of higher interest rates on the horizon, may be fleeting. The front-end of the Canadian yield curve has already responded to the Bank of Canada's more hawkish tone. However we expect the back-end of the yield curve to catch-up with the rise in the front-end as we view the current yield curve as being far too flat.

In this environment we foresee investors being cautious with 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, provide good relative value. 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; and is well positioned to capitalize on relative value and yield enhancement opportunities.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com