LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Global risk assets rallied in Q4 as the GOP tax-reform bill was finalized. Whereas Treasury yields experienced a consistent backup-up in yields during the quarter, albeit with a flattening yield curve bias, Government of Canada bond yields generally fell through November as the BoC re-iterated its cautious stance in the face of uncertainty (NAFTA negotiations, B-20 mortgage rules and the impact of rising interest rates on highly indebted households). However, with the release of November's strong Labour Force Survey, rate hikes expectations surged, raising short and mid-term yields. Amidst this positive risk sentiment, domestic credit tightened by an average of 9 bps.

For the quarter, short, mid and long-term corporate yield spreads tightened by 10, 8 and 9 bps respectively. The relatively even narrowing of credit spreads across the yield curve, was representative of the broad-based risk-on market sentiment. Duration was a big determinant of absolute returns as the underlying Government of Canada yield curve flattened: 2 and 5-year yields rose by 15 and 11 bps respectively, while 10 and 30-year yields fell by 6 and 21 bps respectively. Fourth quarter returns were 0.49%, 1.33% and 4.95% 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 came from lower-rated, higher yielding issues in oil and gas, energy generation, real estate and autos. There was a bias towards higher credit quality moving out the credit curve as the spread narrowing between A-BBB credit became less pronounced. In the long-end, utilities and pipelines generally outperformed, while financial services (GE Capital), industrials (Cameco, Teranet) and securitization underperformed.

With the prospect of higher rates on the horizon, issuers looked to promptly term out bank debt, prefund upcoming maturities, and refinance callable bonds. A total of $21.6 billion of new issues were launched in Q4, capping off a record year of Canadian and global issuance. Following a global trend, BBB-rated issuance accounted for 29% of all domestic primary issuance for the year, compared to the 25% share for calendar year 2016. Notably, in the US, BBB rated issuance increased from 44% to 52%, a majority of investment grade corporate issuance.

Portfolio Activity

Exposure to non-viable contingent capital (NVCC) was reduced after significant outperformance (purchases were made at all-time wide yield spreads), and given our view that the technical and fundamental drivers behind the NVCC rally have largely played out. On the back of new issuance supply pressures, exposure to short and mid-term senior bank, insurance and pipeline debt was increased, providing a relatively higher degree of breakeven protection for rising bond yields. The portfolio's duration and credit quality bias were maintained.

What Worked In The Quarter

The portfolio's credit exposure was overweight shorter dated, higher yielding issues in top performing sectors: oil and gas, media, NVCC and senior debt of non-systemically important domestic banks.

What Did Not Work In The Quarter

The portfolio was structured with a more conservative, defensive bias relative to the index and as a result had a lower running yield. The portfolio has been positioned for rising yields and a steeper yield curve with an overweight in the 5-year area of the yield curve in lieu of long bonds.

Outlook & Strategy

There is an increased risk that corporate spreads will be pressured as they have been buoyed by (a monetary accommodation driven) supply/demand imbalance, which with the prospect of higher interest rates on the horizon, may be fleeting. Elevated leverage metrics coupled with the growth of the BBB-rated debt class has also made the domestic corporate market more sensitive to global event risk and higher interest rates (eroding debt-service capacity). In recognition of these near-term risks and given the expectation that the Canadian yield curve will steepen, the portfolio will retain its duration, yield curve steepening and credit quality bias.

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 about forty percent 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