March 31, 2018

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

During Q1, shifts in credit spreads were largely correlated with changes in equity markets. Canadian credit markets rallied through January amidst a backdrop of strong macroeconomic data, an uptick in corporate earnings, foreign buying, rising commodity prices and the annual “new year’s technical bid”. Sentiment thereafter, soured and volatility surged to the highest levels since 2015, as lofty valuations, rising interest rates and escalating trade tensions weighed on global risk assets. While the initial equity declines were viewed more as a necessary correction than a deterioration in credit cycle fundamentals, appetite for credit continued to deteriorate through March.

Domestic credit spreads widened by an average of 6 basis points during the quarter, which, when combined with the underlying flattening government yield curve, resulted in higher short, mid and long-term corporate yields, by 16, 12, and 4 bps respectively. Running yield was however, able to offset the losses stemming from rising overall yields, as short, mid and long-term corporate bonds returned 0.25%, 0.29% and 0.39% respectively, according to the FTSE TMX Canada All Corporate Bond Indices.

With energy prices stabilizing, higher-yielding issues in energy and generation broadly outperformed across the credit curve. Sectors positively impacted by rising interest rates – insurance and senior bank debt – also generally outperformed. Conversely, as the risk tone softened, liquid higher-beta sectors – bank non-viable contingent capital (NVCC), telecom and pipelines – underperformed as investors reduced credit exposure through these lower-rated, liquid proxies, versus attempting to sell less liquid positions. In the long-end, airports materially lagged as supply weighed on the sector and the prospect of a bond-friendly privatizations became more remote.

Despite an environment of elevated intra-day volatility, frequent issuers were able to tap the primary market for $20.6B in the quarter. The largest uptick in issuance came from domestic banks ($7.5B) as unfavourable swap levels deterred US dollar issuance in lieu of domestic issuance. Significant issuance also emerged from autos ($2.7B), REITS ($2.7B), maples ($1.8B) and telecom ($1.2B). Despite material spread concessions and heavy oversubscription, many issues were unable to retrace concessionary pricing due to market moves, putting acute pressure on secondary prices of similar issues.

Portfolio Activity

The portfolio eliminated exposure to NVCC debt in late January via an increase in senior deposit notes. The bank subordinated/senior basis at this time was at cycle narrows and NVVC debt materially underperformed thereafter. As the credit curve flattened, the portfolio also reduced exposure to long-term utility credit and increased exposure to telecom and senior bank debt issues which will benefit from higher interest rates and a steeper yield curve. 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: energy, insurance and senior bank debt. On a duration-weighted basis the portfolio was underweight NVCC, telecom and airport debt which underperformed.

What Did Not Work In The Quarter

The portfolio is structured with a more conservative, defensive bias relative to the index and as a result has a lower running yield. The portfolio has been positioned for a steeper yield curve with an overweight in the 5-year area of the yield curve in lieu of long bonds, however the credit curve flattened by 12 basis points during the quarter.

Outlook & Strategy

Corporate spreads have been buoyed by a monetary policy driven supply/demand imbalance, which with the prospect of higher interest rates, may be fleeting. Elevated corporate 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 the current 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 thirty-six 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.

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