June 30, 2018

LORICA | INVESTMENT COUNSEL INC.

# Focused Corporate Bond

## Market Highlights

Sovereign yield curves bear steepened through mid-May on hawkish Fed comments and a ratcheting down of geopolitical posturing. Amidst this benign backdrop, credit tone was positive as corporate bonds provide a degree of protection against rising yields. Sentiment shifted thereafter, with yield curve flattening (long real yields remain exceedingly low) and credit spreads widening on Italian political turmoil and protectionist US trade actions. Domestic credit was further pressured by heavy June issuance ($9.3B), as issuers seized the window of opportunity stemming from lower yields and the technical bid arising out of the large June coupon payment and resulting index extension.

All told, domestic credit spreads widened by an average of 5 bps during the quarter, which combined with an underlying twisting government yield curve resulted in short, mid and long-term corporate yields to rise by 19, 13 and 2 bps respectively. Running yield was able to offset the losses stemming from rising yields as short, mid and long-term bonds returned 0.33%, 0.17% and 0.78% respectively according to the FTSE TMX Canada All Corporate Bond Indices.

Across the credit curve, higher yielding issues in sectors that were not pressured by supply generally outperformed. This included insurance (new LICAT regulatory capital ratios were higher than expected), telecom (Bell's inaugural $US issuance and timing of spectrum auction reduced supply expectations), and energy and generation (rising energy prices). Notably, pipeline sector returns were mixed as Enbridge bonds rallied on its intention of asset sales and rollup of its four sponsored vehicles, while long-term TransCanada bonds underperformed after it was downgraded by S&P. Similarly, Hydro One pressured utility spreads after it was downgraded by Moody's and placed on negative watch by S&P due to the pending acquisition of Avista. More broadly, in the short and mid-term area, autos (supply and tariffs), senior deposit notes (supply increase of 38% YTD versus last year) and non-viability contingent capital bank debt (NVCC) lagged, while in the long-end, airports bonds fell as the federal government abandoned its two-year privatization study.

## Portfolio Activity

In anticipation of a steepening yield curve, the portfolio eliminated exposure to long corporate bonds via an increase in mid-term bonds. The portfolio also opportunistically increased exposure to interest-sensitive insurance and senior bank debt. The portfolio's duration and high 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 pipelines (Enbridge and Inter Pipeline bonds). The portfolio had no exposure to NVCC 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 17 bps during the quarter.

## Outlook & Strategy

Elevated leverage metrics in conjunction with the growth of the BBB-rated debt class and increase in the proportion of long-term debt outstanding has made the domestic corporate market more sensitive to global event risk and higher interest rates (eroding debt-service capacity). We feel that at current yields, highly rated short and mid-term corporate bonds are attractive on both an absolute and relative value basis.

We feel that the risk of a disorderly selloff is particularly acute for lower-rated debt as high-yield spreads have been artificially buoyed by reduced supply (increase in issuers utilizing risky covenant-lite leveraged loans) and easy financing conditions. With low-term premiums, we also foresee investors being cautious with exposure to higher levered investment grade debt out the credit curve, particularly for those issues with limited secondary market depth.

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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