LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Ongoing trade tensions overshadowed the supportive backdrop for domestic credit produced by rising sovereign yields, constructive earnings tone and moderate new issuance activity ($21B). On average, domestic corporate spreads managed to tighten by 2 bps for the quarter. However, there was significant variance in performance between sectors and issues due to various credit events.

For the Q3, short and mid-term corporate yield spreads narrowed by 5 and 2 bps respectively whereas long-term corporate yields spreads were flat. The bull steepening of the credit curve reflected the preference for shorter-term corporate maturities where break-evens and liquidity are more attractive than for long bonds, and the opposite for underlying Canadas. Duration was a big determinant of absolute returns as 2, 5, 10 and 30- year Government of Canada yields rose by 27, 24, 25 and 21 bps respectively. Spread tightening and running yield were only able to offset capital losses in the short-end, stemming from rising overall yields, as short, mid and long-term corporate bonds returned 0.21%, -0.39% and -1.84% respectively, according to the FTSE Canada All Corporate Bond Index.

Sectors positively impacted by rising interest rates – insurance and senior bank debt – outperformed across the credit curve. The latter's performance was bolstered by its scarcity premium as all senior debt issuance for domestic systemically important banks must be "bail-in-able" going forward. Elevated energy prices resulted in pipelines, integrated energy producers and energy generation to also outperform. In contrast, defensive issues in utilities and infrastructure (airports) underperformed.

Notably, a number of large issuers were materially impacted by credit events during Q3. On the negative end, there were ratings downgrades (Hydro One, Ford), M&A activity/expectations (AltaGas, Enercare, Canadian Utilities Ltd.), earnings/guidance concerns (Dollarama, GM, Daimler, SNC Lavalin) and supply overhang (CI Financial, Power and IGM Financial, Saputo). Conversely, on the positive end, there was Enbridge (asset sales and debt friendly corporate simplification), specific Thomson Reuters issues (redemption from proceeds of F&R business), Cameco (tax ruling win) and Canadian Natural Resources (ratings upgrade) which saw credit uplifts.

Portfolio Activity

On the back of supply pressures, the portfolio exposure to asset backed and energy issuers was increased via a reduction in media debt which had significantly outperformed. The portfolio's duration, yield curve, sector 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: media, banks (senior deposit notes), insurance and pipelines (Enbridge and TransCanada). The portfolio had no exposure to the issuers (above) that were negatively impacted by credit events. The portfolio has been positioned for higher yields with an overweight in the 3 and 5-year area of the yield curve in lieu of long bonds.

What Did Not Work In The Quarter

The portfolio is overweight short auto debt relative to the index, which was dragged down by Canadian/US trade tariff fears and negative results from Ford and GM.

Outlook & Strategy

Elevated leverage metrics in conjunction with the growth of the junk debt market 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 (which erode debt-service capacity). At current yields, highly rated, liquid, short and mid-term corporate bonds are attractive on both an absolute and relative basis, particularly versus high yield and leveraged loans. Noting that the difference between higher and lower quality spreads are at their tightest since the credit crisis.

We feel that the risk of a disorderly selloff is particularly acute for lower-rated debt as the market has limited capacity to absorb junk debt outflows and high-yield spreads have been artificially buoyed by easy financing conditions (increased usage of covenant-lite leveraged loans) and reduced supply. 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 will be negatively impacted by higher interest rates; and is well positioned to capitalize on relative value and yield enhancement opportunities.

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