LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Volatile financial markets, ongoing US-China trade tensions and the decline of energy prices weighed on global credit during the quarter. Although not immune to the macro environment, domestic investment grade credit remained solid, significantly outperforming riskier credit classes. The portfolio and Canadian credit according to the FTSE Canada Corporate Index returned 1.21% and 0.86% respectively versus -4.85%, -3.76%, -0.40% and -0.42% for US high-yield, leveraged loans, and US and global investment grade credit respectively, according to the Bloomberg Barclays, S&P/LSTA CAD hedged indices.

The outperformance of Canadian credit was a function of: Canada's sovereign strength – one of a handful rated AAA by S&P, and the composition of the domestic investment grade corporate universe – largely regulated domestic-centric business models with little exposure to volatile, commodity and un-integrated energy businesses (many of which primarily issue in the high yield or US markets).

General risk aversion resulted in domestic investment grade corporate spreads widening by an average of 36 bps during Q4, with an investor bias for shorter-term debt, which provides a degree of breakeven protection for rising corporate yields. Corporate returns were buoyed by the bull steepening of the underlying government yield curve, resulting in short, mid and long-term yield moves of -4, -2 and 3 bps respectively.

Across the credit curve, the best spread and absolute performance was reserved for higher-rated securitization, bank deposit notes and insurance and defensive issues in infrastructure and utilities. Conversely, lower-rated, higher-beta issues in retail (Loblaw), autos (Ford and GM), media (Shaw), pipelines (AltaGas), real estate, oil (Husky) and financial services (GE Capital) generally underperformed. Relative performance on a ratings basis reflected the defensive credit risk shift as BBB-rated debt significantly underperformed across the credit curve.

Portfolio Activity

On the back of widening corporate spreads, we took the opportunity to increase duration exposure to credit via positions in highly rated insurance and bank debt. Retail issues were pressured by concessionary pricing on new supply, and with the resulting increase in relative value, and given no portfolio exposure to retail, additions to the portfolio were made. General duration, yield curve, sector and high credit quality bias were maintained.

What Worked In The Quarter

The portfolio had no exposure to lower-rated, longer-dated, higher-beta credit which significantly underperformed as credit weakened and credit curves steepened. In addition, the portfolio had no exposure to higher-beta (but higher-rated), subordinated non-viability contingent capital bank debt. Credit exposure was overweight and concentrated in highly rated short-term senior bank, insurance and securitization debt which were top performers.

What Did Not Work In The Quarter

The portfolio was underweight relatively illiquid infrastructure debt relative to the benchmark, which generally outperformed.

Outlook & Strategy

Restrictive global financing conditions are placing greater strain on riskier credit classes, such as high-yield, leveraged finance and emerging markets. Domestically, debt servicing metrics remain healthy, despite elevated leverage metrics, and refinancing risks do not appear to be a near-term threat, even amongst the lowest rated investment grade names. We feel that higher-rated, liquid, short and mid-term corporates are attractive on both an absolute and relative value basis, particularly versus less-defensive global credit which are vulnerable at this stage of the credit cycle.

As the fourth quarter demonstrated, lower-rated debt is extremely susceptible to a disorderly selloff given the bond markets limited capacity to absorb junk debt outflows. US high yield spreads have been artificially narrow – albeit 210 bps wider in Q4 – after years of easy financing conditions through the increased usage of covenant-lite leveraged loans. However, for the first time since the credit crisis, there was no new issuance in the US high-yield market during December. With low term-premiums, we also foresee investors being cautious with exposure to higher levered investment grade debt with longer maturities, particularly for those issues with limited secondary market depth.

The portfolio possesses good liquidity and is structured conservatively with a significant underweight in BBB-rated debt and no exposure to higher-beta, subordinated non-viability contingent capital bank debt. The portfolio is well positioned to capitalize on relative value and yield enhancement opportunities.

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