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LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Investment grade credit rallied through mid-February as credit spreads tightened on positive sentiment, supportive monetary policy and rising energy prices which overshadowed unresolved stress points (e.g. US-China trade tensions and Brexit). Credit extended gains thereafter, albeit at a slower pace, while sovereign yield curves "bull-flattened" as central banks walked-back tightening guidance. Canadian corporate bonds were bolstered further by foreign investor demand for Canadian issuers given Canada's relatively stable fundamental backdrop, reduced trade uncertainty, and strengthened currency (amidst USD weakness). In contrast, riskier credit classes such as high yield, leveraged loans and preferred shares significantly underperformed once sovereign yields bull flattened.

For the quarter, short and mid-term corporate yields fell by 51, 60 and 44 basis points respectively, resulting in absolute returns of 2.25%, 4.72% and 6.98% respectively, according to the FTSE Canada All Corporate Bond Index. Corporate spread tightening of 20, 25 and 15 bps for short, mid and longs, respectively resulted in "bull steepening" of the corporate yield curve. Long corporate yields lagged the move lower due to less attractive breakeven levels and continued supply pressures in the long-end. Issuance year-to-date has on average been longer-dated and of larger issue-size, increasing re-pricing risk for comparable long-term secondary issues.

An increased appetite for risk was evident in sector performance as higher-yielding, lower-rated issues in oil and gas, pipelines and telecom broadly outperformed. Bank debt also broadly outperformed due to its role as a liquid corporate proxy and strong foreign demand reducing domestic funding requirements. Weakest returns came from defensive issues in transportation infrastructure, utilities and public-private partnerships. Downgrades of SNC Lavalin and TransAlta also weighed heavily on industrial and energy generation performance.

Portfolio Activity

We opportunistically added issues in domestic banks, telecom and oil and gas that were under short-term pressures due to supply and headline risks. The portfolio's duration, yield curve, industry and high credit quality bias were maintained.

What Worked In The Quarter

The portfolio's corporate holdings were concentrated in short and mid-term bonds which benefitted from credit curve steepening. Industry concentrations were in top performing, higher-rated senior bank debt, pipelines, telecom, integrated oil and insurance. The portfolio had no exposure to infrastructure, utilities or industrials which lagged.

What Did Not Work In The Quarter

The portfolio was more conservatively structured with a relatively short duration and overweight in the short and mid-term areas of the yield curve in lieu of long-bonds.

Outlook & Strategy

The environment should remain favorable for domestic investment-grade bonds as supportive monetary policy and durable credit metrics have reduced the risk of a disorderly selloff. However, we feel that the risks remain elevated for more speculative credit classes, such as high yield, leveraged finance and emerging markets. Given the market's risk tolerance and capacity to absorb riskier debt outflows, we believe there is greater probability of a repricing cycle becoming self-reinforcing.

Domestically, while leverage metrics remain elevated, debt servicing metrics remain healthy and refinancing risks do not appear to be a near-term threat, even amongst the lowest rated investment grade names. We feel that highly rated, liquid, short and mid-term corporates are attractive on both an absolute and relative value basis, particularly versus less defensive global credit which is vulnerable at this stage of the credit cycle. Unlike in the US, a profit correction should not result in widespread downgrades of BBB-rated debt to high yield in Canada as the bulk of Canadian names are characterized by high leverage but stable business profiles and cash flows. 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. The portfolio is well positioned to capitalize on relative value and yield enhancement opportunities.

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