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LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Investment grade credit rallied amidst signals of increased monetary policy accommodation by various central banks. With more sovereign yields plunging into negative territory, investors looked to credit in a hunt for yield, albeit cautiously, with a notable shift to improve credit quality at this late stage of the credit cycle. Domestic credit was bolstered further by an ongoing supply-demand disequilibrium, as foreign investor demand for Canadian issues remained strong due to Canada's relatively stable fundamental backdrop, "reduced" trade uncertainty, and improved outlook for the Canadian dollar (amidst USD weakness).

For the quarter, short and mid-term corporate yields fell by 24, 26 and 29 bps respectively, resulting in absolute returns of 1.36%, 2.68% and 5.06% respectively according to the FTSE Canada All Corporate Bond Index. The credit curve bull-flattened (greater decline for longer maturities), reflecting tighter yield spreads across the curve (by 15, 12 and 8 bps respectively) and a greater bull flattening of the underlying government yield curve. Long corporate spreads lagged due to investor's preference for term risk over credit risk. The same cautious stance was evident in Canadian and US high yield markets which returned 0.85% and 2.20% respectively according to the FTSE Canada High Yield Bond Index and Bloomberg Barclays US Corporate Hedged CAD High Yield Index.

On a sector basis, across the short and mid-term areas of the curve, lower rated, higher beta issues in autos, pipelines, energy generation and subordinated bank debt outperformed, whereas in the long-term area, lower beta (defensive) issues in utilities and infrastructure broadly outperformed. Conversely, the weakest performance was logged by the aforementioned defensive sectors and senior bail-in bank debt (supply pressures) in the short and mid-term areas of the curve whereas energy generation, financial services, telecom and real estate lagged in the long-term area.

Portfolio Activity

We opportunistically added issues to the portfolio in domestic banks, pipelines and autos that were under short-term pressures due to supply and headline risk. The duration, yield curve, industry and high credit quality biases of the portfolio were maintained.

What Worked In The Quarter

The portfolio's corporate exposure was concentrated in short and mid-term corporates which benefitted from credit curve steepening. The average credit yield spread of the portfolio's holdings tightened by 17 bps on a duration weighted basis versus 10 bps for the benchmark.

What Did Not Work In The Quarter

The portfolio was more conservatively structured with higher credit quality and a shorter duration relative to the benchmark, 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, given the market's risk tolerance and insufficient capacity of the market to absorb riskier debt outflows, which increases the risk of a repricing cycle becoming self-reinforcing.

Domestically, although leverage metrics remain elevated, debt servicing metrics remain healthy and refinancing risk does 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 are vulnerable at this stage of the credit cycle. Unlike the U.S., a profit correction should not result in widespread downgrades of BBB-rated debt to high yield as the bulk of our BBB-rated 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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