September 30, 2019

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Credit rallied through July as the Fed sought to extend the credit cycle (already the longest on record) through a rate cut and dovish policy bias. The Fed's shift from data dependency to positioning for trade and global growth uncertainties induced investors to assume greater duration and credit risk. Sentiment shifted thereafter as US-China trade tensions and softer overseas PMI data resulted in Treasury and Canada curve flattening and credit spread widening. Heading into quarter-end, elevated event risk and easing credit fundamentals took a backseat to the pursuit of yield. All told, domestic credit spreads widened by an average of 5 bps during the quarter.

For the quarter, short-term corporate yields rose by 13 bps, mid-term yields were flat, and long-term yields fell by 10 bps. The yield shifts were largely driven by the underlying twisting government yield curve which resulted in a return of 0.49% for the portfolio. Canadian government yield curve movements echoed similar changes to the Treasury curve, albeit to much a lesser degree, as our economic, inflation and household debt numbers suggest the Canadian economy is in less need of a rate cut than in the US. Domestic credit spreads trended with those of the US, albeit with less volatility, as our credit markets consist predominantly of higher rated issuers with regulated domestic-centric business models and little exposure to commodity and unintegrated energy businesses, many of which primarily issue in the high yield or US markets.

Across the yield curve, the best spread and absolute performance was reserved for higher yielding issues in retail (Loblaw, Dollarama), real estate, insurance and pipelines (Enbridge). Bank debt also broadly outperformed due to its role as a liquid corporate proxy and the strong foreign demand which reduces domestic funding requirements. Underperforming industries were primarily defensive, lower-beta issues in public/private partnerships (illiquid issues), infrastructure (airports), utilities (CU Inc.) and issuers impacted by credit rating downgrades (SNC, ENMAX, Ford and Daimler). On a ratings basis the reach for yield was evident as BBB-rated debt generally outperformed across the curve.

Portfolio Activity

The portfolio's exposure to insurance and utilities was increased via a reduction in legacy domestic senior bank debt which had outperformed. The portfolio's duration, yield curve, industry and high credit quality bias were maintained.

What Worked In The Quarter

The portfolio's credit exposure was concentrated in shorter-dated, higher yielding issues in industries which out-performed: domestic senior bank debt, insurance and pipelines. Credit spread widening for the portfolio's corporate holdings were less than half that of the benchmark and were significantly less volatile.

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 via an overweight in the short and mid-term areas of the yield curve in lieu of long-bonds.

Outlook & Strategy

We expect increased headwinds for earnings and cash flows given trade and global growth uncertainties. However, supportive monetary policy and durable credit metrics have reduced the risk of a disorderly selloff for domestic investment-grade bonds. We feel that risks for speculative credit classes remain elevated given that credit profiles are significantly weaker than what was seen in comparable past downturns and given the market's fleeting risk tolerance and limited capacity to absorb riskier debt outflows during times of market stress.

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. Additionally, domestic banks, with increased capital and provision requirements appear well positioned to navigate a deterioration in asset quality.

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 in the US, a profit correction should not result in widespread downgrades of Canadian BBB-rated debt as the bulk of these credits are characterized by high leverage but stable business profiles and cash flows. With low-term premiums, we also foresee the credit curve steepening as investors remain cautious to exposure of higher levered 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. It is well positioned to capitalize on relative value and yield enhancement opportunities.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

T. 647.776.8111 E. info@loricaic.com www.loricaic.com