LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

December 2019

Market Highlights

Despite a tepid start to the quarter, credit market optimism grew in the face of sustained trade and geopolitical tensions. The positive sentiment stemmed from supportive monetary policy, resilient consumers, a waning US/China trade dispute and a rally in equity indices. Fundamental concerns over deteriorating profitability, increased leverage, the maturity of the credit cycle and the mispricing of risk were not top of mind for buyers of debt, even amongst cyclical industries. Amidst this risk-on sentiment, domestic credit spreads tightened by an average of 15 basis points during the quarter, with an investor predilection for lower-rated, higher-yielding, higher beta debt.

Although corporate yield spreads tightened significantly (short, mid and long-term by 15,16 and 14 bps respectively), overall corporate bond returns were dampened by rising underlying Government of Canada yields. Absolute corporate returns for the quarter were 0.52%, -0.21% and -0.56% for the short, mid and long-term, respectively (FTSE Canada All Corporate Bond Indices).

Across the yield curve, the best spread and absolute performance was reserved for the lowest-rated, highest-yielding issues in energy generation and industrial services – many of which have lagged as downgrade candidates; energy exploration and pipelines due to the increase in oil prices; and insurance and bank debt given higher interest rates and a steeper yield curve. Underperforming industries were primarily defensive, lower-beta, less liquid issues in infrastructure (airports), electric utilities (OPG and Hydro One notable exceptions) and public private partnerships (health and transportation). The latter was pressured as S&P highlighted potential downgrade risks from lifecycle services deferral risks; this follows earlier concerns over PPP liquidity and downgrades as a number of prominent construction companies (Carillion, Fluor and SNC Lavalin) became distressed in prior years. Relative performance across ratings reflected a strong appetite for risk as lower-rated debt outperformed across the curve.

Portfolio Activity

After corporate yields rose and the credit curve steepened, duration exposure to mid-term pipelines and domestic financials was increased via a reduction in short-term pipeline debt. The latter had outperformed and was trading through higher-rated credit in the short-term area of the credit curve. The portfolio's duration, yield curve, industry and high credit quality bias were maintained.

What Worked In The Quarter

Although the portfolio possessed higher credit quality relative to the benchmark, credit spread narrowing for the portfolio's corporate holdings was greater than that of the benchmark and was significantly less volatile. The portfolio's credit exposure was concentrated in higher yielding issues in top performing industries: insurance, pipelines, telecom and domestic senior bank debt.

What Did Not Work In The Quarter

The portfolio was more conservatively structured relative to the benchmark with an overweight in the mid-term (5-7 year) area of the yield curve in lieu of long-bonds. Driven by higher underlying sovereign yields, the mid to long-term credit curve flattened by 6 bps.

Outlook & Strategy

We expect increased headwinds for earnings and cash flows given geopolitical and trade uncertainties clouding the prospects for global growth. 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 corporate bonds 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, and is well positioned to capitalize on relative value and yield enhancement opportunities.