LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

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Market Highlights

Credit markets rallied in Q2 as central bank commitments to underpin the credit markets via corporate bond purchases included in their quantitative easing programs took effect. Despite limited purchases, the adoption of corporate QE programs dramatically improved investor sentiment, liquidity and primary issuance. Credit spreads subsequently narrowed by 84 basis points for the quarter, with lower-rated, higher-beta and subordinated debt outperforming, notwithstanding global potential downgrades reaching an all-time high.

The Bank of Canada (BoC) Corporate Bond Purchase Program (CBPP) became operational in late May, to support the functioning of the corporate debt market by alleviating dealer balance sheets through secondary market purchases. Consequently, with secondary market tone firming, to the end of Q2, the $10B CBPP had purchased just $139M of bonds originated by Canadian non-deposit-taking firms with a remaining maturity of up to five years and a minimum credit rating of BBB. Notably, the BoC program differs from the Fed's purchase program in its length (1-year term versus the end of Q3 for the Fed), breadth (BoC program limited to investment grade credit), investable instruments (BoC will not be purchasing ETF's) and its forgoing of a complementary primary market program – reflective of our higher-rated, less volatile credit market. While BoC purchases under the CBPP have been subdued, the corresponding purchase of $101B of government securities reduced all-in yields for issuers, leading to a record Q2 corporate issuance of $45.1B.

With QE programs focused on five-years and under maturities and given the improved financing conditions, credit spread curves bull steepened with corporate spreads further out the curve underperforming. For the quarter, short, mid and long-term corporate spreads tightened by 107, 94, and 61 bps respectively. Credit returns were bolstered by the decline in yields of the underlying Government of Canada yield curve, as 2, 5, 10 and 30-year yields all finished the quarter lower by 14, 24, 18 and 33 bps respectively.

The best corporate spread and absolute performance were reserved for higher-yielding issues in oil and gas (rebound in energy prices), pipelines, autos (rating agencies patient on additional downgrades), insurance (Lifeco fixed-floaters), telecom (essential service), retail (consumer staples) and subordinated NVCC domestic bank debt (easing concerns of extension risk). Alternatively, underperforming industries were split between higher-rated, defensive issuers (infrastructure, utilities) and industries harmed most by containment measures (airports, retail and health real estate, long-term care providers, mortgage finance). Senior bank debt performed in-line after banks reported mixed Q2 earnings, as profits were negatively impacted by loss provisions and net interest margin headwinds. Despite the banks' spike in provisions and risk-weighted assets, capital and liquidity remained strong, aided by recent OSFI measures.

Portfolio Activity

Given credit curve steepening, exposures to insurance (Lifeco) and regulated electric utilities were increased through reduced exposures to senior domestic bank and retail debt. Portfolio duration, yield curve, industry and high credit quality biases were maintained.

What Worked In The Quarter

The portfolio's term structure was more conservatively structured relative to the benchmark with an overweight in the short and mid-term (3 to 7-year) area of the yield curve in lieu of long bonds. The CBPP prompted a tightening of spreads in 5-year and under credits. The portfolio had no exposure to the industries harmed most by containment measures which underperformed (noted above).

What Did Not Work In The Quarter

The portfolio possesses higher average credit quality and a shorter average duration relative to the benchmark. Lower-rated, higher-beta, subordinated credit generally outperformed and corporate all-in yields fell across the credit curve. Credit curve positioning however offset some of the relative underperformance as the credit curve steepened by 41 bps.

Outlook & Strategy

Funding conditions have improved with the introduction of QE corporate bond purchase programs. However, the issue remains as to whether liquidity can solve deteriorating economic fundamentals, credit metrics and ultimately, solvency. These risks are elevated for speculative grade credit as these lifelines will only forestall and deepen creditor losses given headwinds for earnings and cash flows.

In the domestic market, which is dominated by investment grade credits, leverage metrics remain elevated, but debt servicing metrics are healthy and refinancing risks do not represent a near-term threat, even amongst the lowest rated names. We feel that highly rated, liquid, short and mid-term corporates are attractive on both an absolute and relative value basis; and while long-term corporates are less attractive, we are cognizant of the fact that central banks may eventually flatten yield curves, thus driving down overall long-term corporate yields.