LORICA
INVESTMENT COUNSEL INC.

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# Focused Corporate Bond

## Market Highlights

Market tone remained constructive for domestic credit in August. Credit spreads tightened by an average of 8 basis points over the month, with short and mid-term higher-beta issues outperforming. Primary issuance was almost exclusively BBB-rated and included many infrequent issuers which priced deals with little to no concession and at the low end of guidance. Concerns over BBB-rated credit with negative outlooks also subsided, notwithstanding global potential downgrades near all-time highs. Downgrade potential remains most extreme in the high yield space, with over half of issuers having a negative ratings bias – ratings with negative outlooks or on credit watch with negative implications.

For the month, short, mid and long-term corporate spreads narrowed by 11, 10 and 4 bps respectively. Short-term corporates continue to be well-bid as evidenced by the absence of any purchases made since June (18 operations) through the Bank of Canada's Corporate Bond Purchase Program (limited to < 5-year maturities).  Credit curve steepening was augmented by the underlying Government of Canada curve steepening, as 2, 5, 10 and 30-year yields rose by 2, 8, 16 and 24 bps, respectively, on the Fed's pledge to let inflation run above target.

The steeper yield curve will be a benefit for the Canadian and foreign retail operations of the domestic banks which saw net interest margin compression in Q3 results. The impact of lower margins was offset by strong capital market activity and modestly reduced provisions for credit losses (levels remain elevated). The bank results, which were in the upper range of expectations, coupled with continued strong and improving CET1 ratios (capital buffers are 90 bps higher than the four U.S. global systemically important banks) were supportive of bank credit and the sector in general. Given the relative funding advantage in the US (~25bps for senior bail-in debt), reduced supply should also be supportive for domestic bank spreads.

Across the yield curve, the best spread and absolute performance was reserved for lower-rated, higher-yielding issues in real estate (retail, office, diversified),  autos, pipelines (Inter Pipeline), oil and gas, domestic non-systemically-important banks (Canadian Western, Laurentian, HSBC) and insurance (Fairfax, Manulife). Credit card ABS also broadly outperformed as collateral performance has remained steady due in part to forbearance programs (minimum payment deferral, late fee waivers) and the Canada Emergency Response Benefit.

Amidst risk-on sentiment, higher-rated issues in defensive industries (utilities and infrastructure) and BBB-rated retail (consumer staples) generally underperformed. The basis between airport and other infrastructure issuer credit spreads continued to widen as the Vancouver Airport Authority was downgraded by S&P on a prolonged traffic recovery period and its intention to increase leverage to finance capital projects. The propensity to take on credit risk decreased with longer maturities as the narrowing of the A-BBB basis was greatest amongst short-term issues.

## Outlook & Strategy

Funding conditions have improved with the introduction of central bank QE corporate bond purchase programs. However, the issue remains as to whether liquidity can solve deteriorating economic fundamentals, credit metrics and ultimately, solvency. We feel these risks are particularly elevated for speculative grade credit as the lifelines will only forestall and deepen creditor losses given increased headwinds for earnings and cash flows. Central bank support of individual high yield issuers will be tested given most do not pose a systemic risk to the economy and almost all carried junk ratings during the longest economic expansion in history.

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. Although long-term corporates are less attractive on a relative value basis, we are also cognizant of the fact that central banks may eventually flatten yield curves, thus driving down overall long-term corporate yields.

The portfolio possesses good liquidity and is structured conservatively. It is well positioned to capitalize on relative value and yield enhancement opportunities.