LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Commentary

Corporate spreads were volatile in February but closed the month 5 basis points tighter on average. This was the third consecutive month of corporate yield spread narrowing. Short, mid and long corporate yield spreads tightened by 4, 7 and 4 basis points respectively, resulting in total returns (which accounts for changes in absolute yields as well as yield-to-maturity) of -0.01%, 0.67% and 1.32% respectively.

The tightening stemmed from a traditional beginning of year increase in investor risk appetite, rising equity markets, an improving macro picture and generally better than expected corporate earnings. Generally, higher beta sectors (e.g. real estate and communication) and lower rated names outperformed early in the month but relinquished much of this return (particularly in the long-end) as Mid-East tensions escalated and energy prices rose. The best spread performance was reserved for subordinated financials (see OSFI below) and insurance, which continues to recuperate from summer wide's.

Appetite for corporate product remained strong in February as new issuance totaled $6.0 billion for the month, which was up considerably from the $3.7 billion in corporate debt placed during the same period last year. Issuance was led by two deposit note deals – BNS and an RBC reopening ($1.5 Billion and $700M 5-year respectively), index ineligible securitizations from Ally (formerly GMAC) and Ford Auto (various maturities of $723M and $523 respectively) and GTAA ($600M 30-year). The GTAA issue was notable as it came on the back of a call on their notes due in 2013 which like many others issued during the height of the credit crisis, have high Canada calls and are trading near or through these levels, posing a risk for investors.

Beyond these deals, issuance was dominated by frequent investment grade issuers (GE Capital Canada, Toyota, Nav Canada) which were less impacted by Mid-East driven volatility. Noticeably absent were higher yielding, lower-rated, non-financial or infrequent issuers, with only one high yield issue coming to market (Vermillion $225M) despite a long list of names (i.e. NAL, Kruger, Perpetual Energy) rumored to be in the pipeline.

The much anticipated communiqué from the Ontario Superintendent of Financial Institutions (OSFI) arrived in February, clarifying OSFI's position with regard to banks utilizing the Regulatory Event call feature of new or third generation high coupon "par call" innovative Tier 1 bonds. Many of these hybrid bonds, that were trading at hefty premiums as late as this summer, had fallen dramatically in price as concerns arose that the new Basel guidelines would encourage banks to exercise the call provision. OFSI ultimately decided that unless under duress, they do not want banks exercising these calls, materially increasing the likelihood that these bonds will be redeemed at their stated redemption date

Portfolio Activity

There was no portfolio activity for the month.

Outlook & Strategy

Although there are still many areas of economic uncertainty, in the near term, domestic corporate bond market returns will be more impacted by supply, regulatory events, European sovereign concerns and geopolitical events, than a significant degradation in the general quality of credits.

On the supply side, we should see increased issuance from Energy, Utilities and Public Private Partnerships. If there are no unexpected surprises on the economic front we also expect to see increased issuance of asset backed securities, high yield, higher beta sectors and Maple issuers. The biggest wildcard in our issuance forecast relates to the sector with biggest refinancing needs, financials. Slow loan growth, attractive funding levels in the Yankee market, and significant pre-funding of 2011 maturities would suggest a decline in issuance however pressures from new regulatory liquidity and funding requirements (albeit with a long phase in period) and the possible crowding out of domestic banks in international markets may result in higher domestic issuance needs.

We are increasingly concerned with the possibility of more shareholder friendly initiatives particularly via share buybacks and increased dividends. Dividend yields in many cases are much higher than after-tax debt costs and after a few years where debt concerns where of foremost concern, boards will be incentivized to reward shareholders their "just deserts". As a caveat however, Canadian companies have tended not to resort to debt funded shareholder friendly initiatives given the importance placed on ratings stability. In the same vein, we think the heady days of debt funded M&A activity seen in the last credit cycle is still a ways off and will be limited to companies with already strong balance sheets and acquisitions that will accrete to earnings quickly.

Gary Morris, CFA
President

Thomas Gomes, CPA, CFA
Portfolio Manager

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