LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Commentary

The year started off well for corporate bonds as yield spreads tightened by 5 basis points on average over the month of January. The tightening stemmed from a traditional beginning of year increase in investor risk appetite, an improving macro picture and Q4 US financial results, which disappointed equity markets but were viewed as relatively stable for credit quality. Despite this improvement, the direction of spreads generally, remains tied to global equity markets as fundamentals continue to take a back seat.

Corporate issuance amounted to $6.0 billion for the month, which was a record setting number for January and nearly double the $3.3 billion in corporate debt placed during the same period last year. Issuance may have been even higher had a piece of the considerable Yankee issuance – $5.75 billion in covered bonds and senior deposit notes, that the Canadian banks undertook south of the border had instead been issued domestically. There was still some domestic issuance by the banks as RBC and CIBC launched $1.3 and $1.0 billion 5 year deposit note deals respectively.

Beyond these jumbo deals, issuance was a hodgepodge of infrequent issuers (VW Credit Canada, Inter Pipeline), real-estate names (RioCan REIT, First Capital, H&R) and Maples (Met Life, Morgan Stanley) - all of which took advantage of backdrop that was favorable for higher-yielding, non-financial or infrequent issuers, as there continues to be a premium attached to name diversification.

For the month, short, mid and long corporate yield spreads tightened by 3,6 and 5 basis points respectively, resulting in absolute returns (which accounts for changes in the yield curve) of 0.40%, 0.12% and -1.09% respectively. Generally, higher beta sectors (e.g. real estate and communication), lower rated names and subordinated issues outperformed; whereas defensive sectors (e.g. pipelines) underperformed. The best spread performance was reserved for insurance issues, which continue to recuperate from summer widening, and bank Tier 1 hybrids which offer scarcity value in the face of upcoming regulatory pronouncements.

Portfolio Activity

Jan 21 – Sold Aeroports De Montreal 5.67/37 and GE Capital Canada 5.29/12 and purchased Enbridge Pipelines 6.62/18 and GE Capital Canada 5.53/17.

Outlook & Strategy

The themes that shaped the corporate market in 2010 – improving credit metrics, strong investor demand, heavy and opportunistic issuance, Basel reforms, European sovereign concerns, ratings stability and historically low all- in-cost yields – will also be the predominant themes in 2011. Although there are still many areas of economic uncertainty, in the near term, domestic corporate bond market returns will be more impacted by supply and regulatory events than a significant change 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, are 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