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Focused Corporate Bond

Market Highlights

Global risk assets rallied in November as the GOP tax-reform bill gained traction. Whereas Treasuries saw a backup-up in yields (albeit with a flattening yield curve bias), Canadian bond yields generally fell. Driving the divergence was the Bank of Canada re-iterating its cautious stance in the face of economic uncertainty (i.e. NAFTA negotiations, B-20 mortgage rules and the impact of rising interest rates on highly indebted households). Amidst positive global risk sentiment and lower government yields, domestic credit tightened by an average of 2 bps.

For the month, short, mid and long-term corporate yield spreads tightened by 2, 3 and 2 basis points respectively. The parallel shift tighter of the credit curve relative to government bonds was reflective of the broad-based risk-on market sentiment and investor hunt for yield. Corporate returns were further buoyed by the flattening of the underlying government yield curve as Canada 2-year yields rose by 4 bps, 5-year yields were flat, and 10 and 30-year yields fell by 7 and 8 bps respectively. The result was absolute returns of 0.17%, 0.61% and 1.70% for the short, mid and long-term FTSE TMX Canada All Corporate Bond Indices respectively.

The best spread and absolute performance across the yield curve was found in higher yielding issuers in oil/gas and pipelines due to higher energy prices, real estate from declining yields, and autos – principally the Daimler upgrade. In contrast, senior bank and financial services debt underperformed weighed down by significant issuance. Notable underperformers included Cameco – its S&P outlook was revised to negative from stable on uranium market weakness, and GE Capital Canada – credit metrics expected to be pressured during turnaround plan. On a ratings basis, the variance between performance was narrow across the yield curve with BBB-rated debt outperforming in the short-end, and A-rated debt marginally outperformed in the long-end.

The indebted household sector and the lofty real estate market continued to be a principal area of focus with respect to Q/4 bank results; however, credit costs turned out to be largely an earnings tailwind. Despite some variation due to seasonality, asset quality was broadly stable. Royal Bank's provision for credit losses ratio at 17 bps was particularly noteworthy as it fell to pre-credit crisis lows. The uninsured real estate secured lending books remained strong with an average loan-to-value of 53% and an improvement in delinquency trends. The spotlight will now shift to January, when more restrictive mortgage lending rules (B-20) come into effect, as will the impact on originations and home prices.

The pace of new issuance rose on the back of supportive market tone and embedded demand from the December 1st coupon payments and corresponding index extension. Of the $11.1 Billion of new deals that were priced for the month, significant issuance came from the domestic banks ($5.8 Billion in senior deposit notes), Metro (three tranches totaling $1.2 Billion, autos ($1.1 Billion) and insurance ($1.1 Billion). The deposit note deals were the first domestic bank issuance in two months – an uncharacteristically long-time frame in this environment – as domestic banks were instead active in foreign markets, given their appeal on a relative pricing basis and the funding diversification.

Outlook & Strategy

There is an increased risk that corporate spreads will be pressured as they have been buoyed by (a monetary accommodation driven) supply/demand imbalance, which, with the prospect of higher interest rates on the horizon, may be fleeting. Elevated leverage metrics coupled with the growth of the BBB-rated debt class has also made the domestic corporate market more sensitive to global event risk and higher interest rates, eroding debt-service capacity. In recognition of these near-term risks and expectation that the Canadian yield curve will steepen, we will retain the portfolio's short duration, steepening yield curve bias, and better credit quality.

In this environment we expect investors to be cautious with exposure to higher levered debt out the credit curve, particularly for those issues with limited secondary market depth. However, corporate spread levels, which currently represent about forty percent of all-in yields, still provide good relative value. The portfolio possesses good liquidity, is structured conservatively with minimal exposure to sectors or issuers that would be negatively impacted by higher interest rates; and is well positioned to capitalize on relative value and yield enhancement opportunities.

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