April 30, 2019

LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Credit extended its rally in April as the shifts by the Bank of Canada and the Fed to dovish policy biases along with broadly easier financial conditions sustained the very mature credit cycle – at 122 months, we are now in the longest ever equity bull market in the US (according to the S&P 500). While both central banks reduced GDP and inflation forecasts, amidst a slowdown in global growth and ongoing trade-uncertainties, domestic investment grade corporate results were less sluggish. In general, earnings have been supportive of credit profiles, despite moderating revenue growth. Risk-on sentiment was further supported by a dip in primary issuance for the month.

All told, corporate spreads narrowed by 9 bps during April, with investors preferring liquid, shorter dated, higher beta debt. This preference was evident from the steepening of the credit spread curve, whereby short, mid and long-term corporate yield spreads narrowed by 11, 10 and 5 bps respectively over the month. In the long-end, corporate returns were further dampened by the steepening effect of the underlying government yield curve as Government of Canada 5 and 30-year yields rose by 1 and 9 bps respectively. Short, mid and long-term corporates returned 0.48%, 0.52% and -0.20% respectively for the month.

Across the yield curve, the best spread and absolute performance was reserved for higher-beta issues in telecom, autos, oil and gas, retail, and insurance. Notably, bank debt also outperformed due to reduced domestic supply from banks, who preferred to issue internationally, where foreign funding costs remain relatively attractive compared to domestic levels. Weakest returns came from defensive issues in transportation, infrastructure, utilities and public-private partnerships.

Early month credit rating downgrades and expected issuance from TransCanada and Enmax put pressure on their respective spreads, although both retraced some of the spread widening by month-end. On a ratings basis, BBB-rated debt outperformed across the curve although the degree of relative outperformance versus A-rated debt decreased with the extension of term.

In the absence of domestic bank issuance, primary issuance was contained to $6.8 Billion, the majority of which came from opportunistic and BBB issuers in the utility ($2 Billion), pipeline ($1.8 Billion), telecom ($1 Billion) and US bank ($1 Billion) sectors. Reduced issuance and a number of fixed size launches (rather than a minimum size at launch) – helped to reduce new issue pricing concessions and placed less pressure on secondary issues.

Outlook & Strategy

The environment should remain favorable for domestic investment-grade bonds as supportive monetary policy and durable credit metrics have reduced the risk of a disorderly selloff. We feel however that the risks remain elevated for more speculative credit classes, such as high yield, leveraged finance and emerging markets. Given the market's risk tolerance and capacity to absorb riskier debt outflows this increases the probability that a repricing cycle becomes self-reinforcing.

Domestically, while leverage metrics remain elevated, debt servicing metrics remain healthy and refinancing risks do not appear to be a near-term threat, even amongst the lowest rated investment grade names. We feel that highly rated, liquid, short and mid-term corporates are attractive on both an absolute and relative value basis, particularly versus less defensive global credit which are vulnerable at this stage of the credit cycle. We feel that, unlike in the US, a profit correction should not result in widespread downgrades of BBB-rated debt to high yield, as the bulk of our BBB-rated names are characterized by high leverage but stable business profiles and cash flows. With low-term premiums, we also foresee investors being cautious with exposure to higher levered investment grade debt out the credit curve, particularly for those issues with limited secondary market depth.

The portfolio possesses good liquidity and is structured conservatively with a significant underweight in BBB-rated debt. The portfolio is well positioned to capitalize on relative value and yield enhancement opportunities.

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