LORICA | INVESTMENT COUNSEL INC.

Focused Corporate Bond

Market Highlights

Domestic investment grade credit spreads continued their march tighter in February, albeit at a slower pace than what was seen in January. With steady credit conditions, credit (and risk assets in general) have extended gains on central banks potentially shifting back into easing territory over concerns of slowing economic growth and growing geopolitical headwinds. In this environment, Canadian credit has continued to outperform global peers due to Canada's relatively stable fundamental backdrop and relatively reduced trade uncertainty (limiting downside event risk). While rising commodity prices and a strengthening Canadian dollar (amid USD weakness) are acting as positive catalysts.

For the month, short and mid-term corporate yields fell by 5 and 2 bps respectively, whereas long-term corporate yields rose by 2 bps. This resulted in absolute total returns of 0.37%, 0.43% and 0.11% respectively according to the FTSE Canada All Corporate Bond Index. The bear steepening of the credit curve reflects the continued investor preference for increased credit quality as one extends out the curve, particularly given the lower long-term breakeven levels amidst the current environment of elevated global event risk. Additionally, despite a significant drop in primary issuance of approximately 20% year-to-date versus the same period last year, the new issuance that has emerged has on average been longer-dated and of larger issue size, increasing repricing risk for comparable long-term secondary issues.

Domestic earnings headwinds from slower economic growth were notably absent from Q4 domestic bank results. Given the length of this credit cycle, the shifting loan mix to more cyclical, capital intensive and concentrated commercial loans versus relatively less risky secured consumer loans (the growth of which has slowed due to mortgage growth moderating) bears close monitoring. However, while provisions for credit losses have moved marginally higher, they remain at near-cyclical lows.

A positive surprise for credit investors was the inaugural disclosure of total loss-absorbing capacity (TLAC) ratios which came in stronger than what was implied by senior unsecured public bond issuance to date. Full compliance with the rule is required by November 1, 2021 (bank fiscal Q1/22), however with the domestic banks ahead of schedule in meeting TLAC requirements, funding pressure will be reduced as maturing legacy senior debt is replaced with senior bail-in debt.

Across the yield curve, the best spread and absolute performance was reserved for lower-rated, higher beta debt in telecom, pipelines, auto and retail. Weakest performance came from defensive issues in infrastructure and utilities, and illiquid long-term public-private partnerships issues. Notably, SNC spreads gapped wider (>30bps YTD) on profit warnings, write-downs, rating downgrades and continued exposure to headline risk surrounding the federal government's involvement in the judicial decision to enter into a deferred prosecution agreement with SNC.

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. As was demonstrated last quarter, the market has neither the risk tolerance nor the capacity to absorb riskier debt outflows without material damage being inflicted on prices and liquidity.

While Canadian corporate leverage metrics remain elevated, debt servicing metrics remain healthy and, even amongst the lowest rated investment grade names, refinancing risks do not appear to be a near-term threat. We feel that highly rated, liquid, short and mid-term corporates are attractive on both absolute and relative value bases, particularly versus less defensive global credit which is vulnerable at this stage of the credit cycle. 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; and is well positioned to capitalize on relative value and yield enhancement opportunities.

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