September 30, 2015

Focused Corporate Bond

Market Highlights

In Q3, domestic investment grade credit was buffeted by the drawdown in global risk assets and ongoing constrained liquidity in the secondary market. For the quarter, domestic corporate spreads widened by an average of 24 basis points with increased aversion to issues further out the credit curve and the credit spectrum. Notably, in the current volatile environment, corporate bonds were generally unable to capitalize on periods of risk-on sentiment, as technical factors, such as liquidity, changes in index composition, increase in passive investor base, and ongoing material new issue supply, continued to be a significant driver of returns.

In the quarter, short, mid and long-term corporate yield spreads widened by 25, 24 and 22 basis points respectively, resulting in absolute returns of -0.25%, 0.33% and -0.36% respectively according to the FTSE TMX Canada All Corporate Bond Index. The modest flattening of the yield curve reflected supply pressures, from bank NVCC issuance, in the short and mid-term area of the credit curve and widening of European automakers which are primarily shorter-dated issues. On an absolute basis, a rally in underlying government yields was unable to compensate for the widening of credit spreads. For the quarter, underlying 2 year government yields rose by 4 basis points whereas 5, 10 and 30 year government yields fell by 14, 24 and 9 basis points respectively.

On a sector basis, the best spread and absolute performance, across the yield curve was generally reserved for higher rated, lower beta issues in utilities, infrastructure and senior bank debt. Alternatively, autos (VW emission scandal) and energy producers (weak commodity prices) underperformed in the short and mid-term area of the credit curve whereas supply pressures resulted in bank hybrid debt and pipelines to underperform in the long-end. On a rating basis, performance between rating classes was similar in the short-term area of the credit curve; however A and AA rated credit outperformed in the mid and long-term area of the credit curve respectively as the widening basis between AA-BBB was positively correlated with term.

With reduced liquidity, there remained a focus on new issuance in lieu of secondary markets. Generally, new issues came with material concessions and most were met with healthy demand, however as a consequence of reduced liquidity, few performed well in secondary trading. Of the $20.7 billion that came to market, significant issuance originated from the banks ($7.8 billion), project finance ($2.8 billion), pipelines ($1.8 billion) and securitization ($1.5 billion).

Portfolio Activity

On the back of supply pressure and the steepening of the credit curve, the portfolio opportunistically increased exposure (on a duration basis) to banks, securitization and insurance debt while reducing exposure to lower- rated retail debt which had outperformed. The portfolio's quality, duration and yield curve bias was maintained.

What Worked In The Quarter

The portfolio was overweight bank debt on both a market and duration weighted basis which outperformed as the most recent quarterly disclosures allayed fears over a significant deterioration of credit quality in the event that energy prices were to remain stressed.

The portfolio's sector exposure distribution benefitted from an overweight in shorter-term higher yielding insurance and bank debt (as a source of alpha).

What Didn't Work In The Quarter

Relative to the index, the portfolio is more conservatively structured with a shorter duration and an overweight in the shorter-term area (<5 year) of the yield curve in lieu of 10 year and long bonds. For the quarter, the underlying government yield curve flattened significantly. Additionally, the portfolio was underweight less liquid issues in infrastructure which were not subject to supply pressures.

Outlook & Strategy

From the perspective of corporate fundamentals, we feel that we have surpassed the credit cycle peak, however in the short-term we do not expect significant degradation in credit metrics. We do feel that in the near term corporate spreads will remain under pressure due to ongoing reduced liquidity and aggressive issuance activity. In the current environment we expect investors to continue to be cautious, limiting exposure to higher beta credit out the credit curve.

Corporate spread levels currently represent over half of all-in-yields and thus provide good relative value. The portfolio is structured conservatively, possesses good liquidity, and therefore is well positioned to capitalize on relative value and yield enhancement opportunities.

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