September 30, 2017

Focused Corporate Bond

Market Highlights

The Canadian corporate bond market succumbed to overwhelming supply pressures despite unexpected strong economic data and constructive earnings during Q3. In the early part of the quarter, corporate bonds outperformed, as the Bank of Canada's first rate hike in seven years, encouraged investors to purchase corporate bonds, given the degree of protection they provide against rising yields. In the latter part of the quarter, as the risk tone softened, the domestic credit markets were pressured as investors struggled to digest record issuance, particularly from opportunistic foreign issuers. All told, domestic credit spreads tightened by one basis point on-average over the quarter, with notable performance coming from shorter-term higher yielding issues.

The preference of investors to avoid term risk resulted in a bull steepening of the credit curve with short-term corporate yield spreads tightening by 4 bps whereas mid and long-term corporate spreads were flat. Narrowing corporate spreads were more than offset by the significant rise of the government yield curve – 2, 5, 10 and 30-year Government of Canada yields rose by 39, 32, 35 and 34 bps respectively on the quarter. Short, mid and long-term FTSE TMX Canada All Corporate Bond Index returns for Q3 were -0.27%, -1.11% and -3.58% respectively.

Carried by the strength of the rally early in the quarter, the best spread and absolute performance were in shorter-dated, higher yielding, lower-rated issues in oil and gas – higher energy prices, insurance – earning and capital tailwind from higher rates, and real estate – Cominar REIT downgrade to junk relief rally. Alternatively, longer dated issues in retail – increasing competition and event risk, and infrastructure – expensive relative to provincials, underperformed.

With the prospect of higher rates on the horizon, issuers looked to promptly term out bank debt, prefund upcoming maturities and refinance callable bonds. Issuance was further buoyed by opportunistic foreign issuers looking to tap a Canadian market longing for name diversification. A record $26.4 Billion came to market, with the most notable deal of the quarter being Apple's $2.5 Billion 7-year Maple issue, which tied RBC for the largest single tranche transaction in the domestic market. Apple was attracted to the Canadian market as it could price its bonds at 80 bps over Government of Canada's – a yield discount of roughly 14 bps to existing US$ issues on a swapped equivalent basis.

Portfolio Activity

On the back of new issuance supply pressures, we increased the portfolio's exposure to shorter-term financial debt, which provides a relative higher degree of breakeven protection for rising bond yields. The portfolio's short duration and bias to higher credit quality with increasing term were maintained.

What Worked In The Quarter

The portfolio has been positioned for rising yields and a steeper yield curve with an overweight in the 5-year area of the yield curve in lieu of long bonds.

The portfolio's credit exposure was overweight shorter dated, higher yielding issues in top performing sectors: insurance, oil and gas, media and senior debt of non-systemically important domestic banks.

What Did Not Work In The Quarter

The portfolio is structured with a more conservative, defensive bias relative to the index and as a result has a lower running yield.

Outlook & Strategy

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

In this environment we foresee investors being 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, provide good relative value. The portfolio possesses good overall credit quality and liquidity, and is structured conservatively with minimal exposure to sectors or issuers that would be negatively impacted in the event of higher interest rates. The portfolio is also well positioned to capitalize on relative value and yield enhancement opportunities.

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