LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

January 2020

Market Highlights

Global markets kicked off the new year on a strong note as credit markets posted gains and corporate spread tightening remained the path of least resistance. Domestic corporate spreads rallied as much as 10 basis points through late January as relatively strong economic data allayed concerns over ongoing geopolitical tensions. However, market sentiment shifted thereafter as the Wuhan Coronavirus outbreak dominated the macro narrative. Investors reduced exposure to higher-beta, lower-rated and longer-dated credit, such that domestic corporate spreads were ultimately unchanged for the month at 1 bp narrower.

With continued demand for short and mid-term credit, given more attractive breakevens, the credit curve steepened with short and mid-term credit spreads tightening by 3 and 4 bps respectively and long-term credit spreads widening by 2 bps. The sell-off in credit was more acute south of the border, where average investment grade and high yield spreads widened by 9 and 54 bps respectively. The outperformance in Canada is largely due to Canadian credit markets consisting of predominantly higher rated issuers with regulated domestic-centric business models and little exposure to commodity and unintegrated energy businesses (many of which primarily issue in the high yield or US markets). Overall returns were driven by the bull flattening of the Government of Canada yield curve as 2 and 30-year yields declined by 25 and 35 bps respectively, which resulted in a return of 2.18% for the portfolio.

Across the yield curve, the best spread and absolute performance was reserved for higher-yielding financial issues in insurance and domestic banks. The latter occurred despite elevated overall domestic issuance of $6 Billion for the month (83% of overall corporate supply versus 55% on average during 2018-19) and global issuance of $24.7 Billion (in the context of expected global maturities of $115 Billion for the coming year). Supply dynamics also benefitted retail issuers as Alimentation Couche-Tard issued two US$750 Million issues in 10-year and 30-year tranches. Finally, lower-rated short-term auto finance debt (Ford and GM) outperformed as investors reached for yield. Notably, Ford bonds lost those gains (and more) following the release of weak Q4 results and guidance in early February, increasing the likelihood of a credit rating downgrade to junk.

Debt of airport authorities underperformed uniformly across the curve as the Wuhan Coronavirus outbreak plays havoc with current travel while leaving much uncertainty around future travel. Of Canadian airports, Vancouver International is the most exposed to the travel-impact of the virus with approximately 17% of passenger traffic originating from or departing to the Asia Pacific. Telecom and utilities also broadly underperformed as the former acts as a liquid higher-beta proxy while the latter was pressured by low all-in long-end yields.

Outlook & Strategy

We expect increased headwinds for earnings and cash flows given uncertainties related to geopolitics, trade and the Coronavirus which will cloud global growth. However, supportive monetary policy and durable credit metrics have reduced the risk of a disorderly sell-off for domestic investment-grade bonds. We feel that risks for speculative credit classes remain elevated given that credit profiles are significantly weaker than what was seen in comparable past downturns and, the market's fleeting risk tolerance, and limited dealer capacity to absorb riskier debt outflows during times of market stress.

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. Additionally, domestic banks, with increased capital and provision requirements, appear well positioned to navigate a deterioration in asset quality.

We feel that highly rated, liquid, short and mid-term corporate bonds are attractive on both an absolute and relative value basis, particularly versus less defensive global issuers which are vulnerable at this stage of the credit cycle. We do not expect a profit correction to result in widespread downgrades of Canadian BBB-rated debt (unlike what is expected in the US), as the bulk of these credits are characterized by high leverage but stable business profiles and cash flows. With low-term premiums, we also foresee the credit curve steepening as investors remain cautious to exposure of higher levered debt with longer maturities, 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. It is well positioned to capitalize on relative value and yield enhancement opportunities.