LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

February 2020

Market Highlights

Growing concerns over the potential breadth and severity of the COVID-19 outbreak continued to dominate the macro narrative. While equity markets bore the brunt of market anxieties, high yield debt was also hurt as risk premiums surged due to increased volatility and challenging financing conditions, reinforcing the safe-haven status of investment grade debt. Co-ordinated monetary policy placed additional pressure on longer-term credit, resulting in steeper credit curves and underperformance of lower-rated, higher beta, longer-dated issues.

For the month, short and mid-term corporate yields fell by 15 and 5 basis points respectively, whereas long-term yields rose by 1 bp. Credit spread widening of 11 bps was more than offset by bull steepening (the 2-30's yield curve steepened by 17 bps) of the underlying Government of Canada yield curve. The selloff in credit was more acute south of the border where average investment grade spreads widened by 20 bps; US high yield was particularly hard hit, with spreads widening by 109 bps. Canadian credit outperformance was due to the prominence of 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) found in the Canadian market. Lower than average monthly primary issuance of $5.6 Billion (across a variety of industries) also aided domestic credit as pressures from supply overhang were reduced.

The repercussions of the global spread of COVID-19 on credit markets has been widespread but has been most severe across the consumer discretionary sector, businesses which are experiencing a disruption in their supply chain, commodities and transportation infrastructure. Tight credit spreads, the low interest rate environment and easy financing has helped sustain the debt servicing ability of these generally lower-rated corporate borrowers, despite credit quality deterioration at this late stage of the credit cycle. Rating agencies, for their part, are viewing the economic and credit implications of the outbreak as a short-term disruption (1-2 quarters) with a rebound in subsequent quarters as consumers release pent-up demand and firms fill back orders and restock inventories.

Risk aversion was evident in sector performance as more defensive, lower-beta, higher-rated issues in infrastructure (ex-airports), utilities, retail (consumer staples) and pensions (non-REIT) generally outperformed across the curve. In contrast, lower rated issues in aviation, autos (Ford and GM), pipeline hybrid debt, oil and gas, longer-dated telecom and bank non-viable contingent capital (NVCC) debt underperformed. The more liquid sectors (telco and NVCC) underperformed as investors reduced credit exposure through these corporate proxies versus attempting to sell illiquid bonds.

Outlook & Strategy

In the face of the COVID-19 crisis, domestic investment credit will continue to offer a relatively favourable risk profile. Given the uncertainties clouding global growth we expect increased headwinds for earnings and cash flows. However, supportive monetary policy and durable credit metrics have reduced the risk of a disorderly selloff 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 given the market's fleeting risk tolerance and limited 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 corporates are still attractive on both an absolute and relative value basis, particularly versus less defensive global credit which are vulnerable at later stages of the credit cycle and more exposed to event risks. Unlike in the US, a profit correction should not result in widespread downgrades of Canadian BBB-rated debt as the bulk of these credits are characterized by high leverage but stable business profiles and cash flows. 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.