LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

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Market Highlights

Global credit markets reacted violently over fears of the global economic downturn spurred from the COVID-19 crisis. Credit spreads widened at a faster pace than during the Lehman Brothers collapse with Canadian Investment Grade (IG), US IG and US High Yield (HY) spreads widening by 170, 280, and 764 basis points on the year at their apex on March 23rd. Thin liquidity conditions were exacerbated by indexed ETF and indexed funds (which were already trading at deep discounts to their underlying securities) which struggled to raise cash amid large outflows. Cash flow liquidity was the dominant concern for corporations as credit lines and revolving lending facilities were drawn and capex budgets cut.

In response to the emerging economic crisis, the Fed announced extensive measures to support corporate liquidity, most notably the Primary and Secondary Market Corporate Credit Facilities, which put a floor under the corporate bond market and resulted in a dramatic rebound in IG credit spreads, created market liquidity and fuelled primary issuance on both sides of the border. Notably both facilities can only buy bonds from and lend to companies with IG ratings, leaving HY bonds without aid. It also came on the back of an aggressive pace of credit rating downgrades, negative outlooks and an increased number of "fallen angels" (IG downgraded to HY) such as Ford.

For the quarter, short, mid and long-term corporate yields rose by 44, 45 and 43 bps respectively. Although yield spreads widened by an average of 140 bps across the yield curve, this was partially offset by the large short-term yield declines of underlying Government of Canadas. Investors relied on the sale of short and mid-term corporates to meet liquidity needs (being the least impaired assets), which meant that long-term corporate prices remained opaque with wide bid-ask spreads (approximately 2-4% of market value for 30 year bonds) and insufficient trade points (over half of long-term issues did not trade in the final half of March). The selloff in credit was more acute south of the border where IG and HY spreads widened by 179 and 543 bps respectively. The Canadian outperformance is largely due to our credit markets consisting of predominantly higher rated issuers with regulated domestic-centric business models and less exposure to cyclical, commodity and unintegrated energy businesses (many of which primarily issue in the HY or US markets).

Risk aversion was evident in sector performance as more defensive, lower-beta, higher-rated issues in senior bank debt, telecom (essential service, no negative credit rating actions), regulated utilities, retail (consumer staples), infrastructure (ex-airports), and pensions (non-REIT) outperformed across the curve. Bank credit was buoyed by regulatory actions on improving short-term liquidity, delinquent loan recognition, reducing the domestic stability buffer and temporarily increasing covered bond limits. Alternatively, lower rated issues in aviation, autos (structural headwinds, credit rating downgrades), oil and gas (energy prices), pipeline (counterparty risk), lower-rated retail REIT's and bank non-viable contingent capital (NVCC) debt underperformed.

Portfolio Activity

After corporate yields rose duration exposure to mid-term industrial services debt was increased via a reduction in securitization debt. The portfolio's duration, yield curve, industry and high credit quality bias were maintained.

What Worked In The Quarter

The portfolio's term profile was more conservatively structured relative to the benchmark with an overweight in the short and mid-term (3-7 year) area of the yield curve in lieu of long-bonds. An overweight exposure in short-term (<5 year) senior bank debt benefitted from Bank of Canada easing and credit friendly regulatory actions.

What Did Not Work In The Quarter

Although the portfolio possesses higher credit quality relative to the benchmark, the portfolio was underweight more defensive but illiquid utility, pension and infrastructure (public-private partnerships) debt which outperformed.

Outlook & Strategy

With the Fed joining the ranks of other central banks in targeting the purchase of IG corporate bonds, we feel the precedent has been set for the Bank of Canada to adopt a similar strategy if needed. We feel that risks remain elevated for speculative grade credit as central banks have determined that these markets, while exposed to increased headwinds for earnings and cash flows, do not pose a systemic risk and as a result are reluctant to include these assets in their asset purchase (QE) programs. This however has also increased the risk of a ratings cliff for fallen angels.

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. We feel that highly rated, liquid, short and mid-term corporates (<10 years) are relatively more attractive on both an absolute and relative value basis particularly as we also foresee the credit curve steepening as cash flow liquidity concerns eventually subside.