LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

April 2020

Market Highlights

Credit markets rallied in April on corporate bond quantitative easing announcements by the Bank of Canada (initiation) and Federal Reserve (expansion of scope) as they signaled a clear commitment to underpin the corporate bond market. The dramatic improvement in investor sentiment, liquidity and primary issuance resulted in corporate spreads gapping in by 48 basis points over the month. Risk-on sentiment generally resulted in the outperformance of higher-beta and subordinated debt issues. However, trepidation surrounding issuers harmed most by containment measures and BBB-rated credits with negative outlooks was also evident.

Taking a cue from the Fed's Secondary Market Corporate Credit Facility, the Bank of Canada (BoC) announced the implementation of the Corporate Bond Purchase Program (CBPP) to support the functioning of the domestic corporate debt market. While operational details still need to be finalized and the program's parameters may be expanded if conditions warrant, the $10B program set to begin in May will purchase senior secured and unsecured bonds originated by Canadian incorporated companies with a remaining maturity of up to five years and a minimum credit rating of BBB or equivalent. Debt issued by deposit-taking institutions will be excluded from the program given their access to other support facilities implemented by the Bank. Clarity is still required on whether the $10B includes leverage (the Fed program can make secondary purchases of 10x leverage on $25B of equity capital) and BBB-negative-rated debt (significant for REIT's), and what the treatment of fallen angels (investment grade debt downgraded to high yield) is. Notably, the BoC action differs from that of the Fed: in length (one-year term versus the end of Q3 for the Fed), breadth (BoC program limited to investment grade credit), investable instruments (will not be purchasing ETF's), and its forgoing of a complementary primary market program – reflective of our higher rated, less volatile credit market.

With QE programs focused on tenors of five years and less and improved financing conditions, credit spread curves bull steepened as corporate spreads further out the curve underperformed. For the month, short, mid and long-term corporate spreads tightened by 59, 55, and 40 bps respectively. Credit returns were bolstered by the drop in yields (averaging 20bps) of the underlying Government of Canada curve. Significantly, record issuance of almost exclusively short and mid term debt – $18.5B (3x the 10-year average and 47% higher YTD than 2019) did not pressure yield spreads in that area of the curve due to strong investor demand.

Across the yield curve, the best spread and absolute performance was reserved for higher-yielding issues in pipelines (Enbridge, TransCanada, Pembina), telecom (essential service, no negative credit rating actions), insurance (lifeco fixed-floaters) and domestic banks. The latter saw subordinated NVCC debt outperform senior legacy and bail-in debt as an upcoming sub-debt June maturity was called, easing concerns of extension risk of Canadian bank capital securities given the announcements from European regulators that requested their financial institutions stop paying dividends and to extend similar securities. Underperforming industries were divided between higher-rated, defensive issuers (infrastructure, utilities), industries harmed most by containment measures, and BBB-rated credit with negative outlooks (real estate, lower-rated autos, energy generation, oil and gas and financial services). News of issuers who suspended share buy-back programs or cut dividends and capital spending to shore up their balance sheets saw a positive (albeit limited) credit spread reaction. Lower-rated retail and healthcare real estate issuers (Ventas, H&R, Morguard, CT, Crombie, First Capital) were the most challenged, despite the rent relief program introduced by the government. Higher-rated, consumer staple and industrial concentrated issuers (Choice Properties, Granite) and pension arms (OMERS, AIMCO and BCIMC Realty) performed in-line or outperformed broader corporates.

Outlook & Strategy

Funding conditions have improved with the introduction of central bank QE corporate programs, but do not solve the obstacles of deteriorating economic fundamentals and credit metrics. We feel this risk is particularly elevated for speculative grade credit as central banks have determined that these markets do not pose a systemic risk and as a result are hesitant to take on excessive credit risk given increased headwinds for earnings and cash flows.

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 are attractive on both an absolute and relative value basis particularly as we also foresee the credit curve steepening as liquidity concerns subside.

The portfolio possesses good liquidity and is structured conservatively. It is well positioned to capitalize on relative value and yield enhancement opportunities.