LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

July 2020

Market Highlights

Credit spreads narrowed and the credit curve steepened in July, as the sound environment for credit continued with generally positive risk sentiment and moderate primary issuance overwhelming a mixed start to Q2 earnings season. Spreads tightened by an average of 20 basis points over the month, with short and mid-term higher-beta issues outperforming. Concerns over BBB-rated credit with negative outlooks subsided, notwithstanding global potential downgrades reaching their all-time high.

Short, mid and long-term corporate spreads narrowed by 25, 22 and 11 bps, respectively over the month. Short-term corporates continued to be well-bid as evidenced by the absence of purchases made under the Bank of Canada's Corporate Bond Purchase Program (limited to < 5-year maturities) during the month. Credit returns were bolstered by the decline of Canada yields: 2, 5, 10 and 30-year's fell by 3, 5, 6 and 6 bps, respectively. The flattening of the Canada yield curve occurred, despite the federal government's debt management strategy update, which projected that $106 billion would be issued in 10 and 30-year bonds. By contrast, only $17 billion had been issued in these maturities in the previous fiscal year.

Limited Recourse Capital Notes (LRCN), a new form of Additional Tier 1 Capital (AT1) to satisfy capital requirements under Basel III, were issued by the Royal Bank of Canada. The notes consist of a callable 5-year note (60-year final maturity) and perpetual, non-cumulative preferred shares (with standard NVCC provisions) issued by the bank to a special purpose vehicle (SPV) for delivery to holders in the event of default or at maturity. LRCN's qualify as non-viability contingent capital (NVCC) and coupons on the LRCN's are tax-deductible for banks, unlike dividends on AT1 preferred shares. The issue was only to be held by institutional investors and was well received; however broader participation is not imminent as the structure was deemed not eligible for domestic bond indices.

Across the yield curve, the best spread and absolute performance was reserved for higher-yielding issues in oil and gas (Husky Energy), insurance (Fairfax, Manulife), pipelines (Enbridge, Inter Pipeline), autos (eased credit rating downgrade concerns) and senior domestic non-systemically important bank debt (i.e. HSBC, Canadian Western). Whereas spread retracement was strong across most sectors, transportation infrastructure spreads were pressured due to the slow recovery in passenger volumes, aeronautical fees and toll revenues. Airports was the worst performing transportation subsector – the Greater Toronto Airport Authority received bondholder consent on temporary relief from their bond covenants for fiscal 2020/21. COVID headwinds also weighed on retail-focused REITs (CT, Riocan, Smart) – deterioration in Q2 earnings and credit metrics, and securitizations (credit card receivables, HELOC) – lower delinquencies were obscured by deferrals and federal aid programs.

Outlook & Strategy

Funding conditions have improved with the introduction of central bank QE corporate bond purchase programs. However, the issue remains as to whether liquidity can solve deteriorating economic fundamentals, credit metrics and ultimately, solvency. We feel these risks are particularly elevated for speculative grade credit as the lifelines will only forestall and deepen creditor losses given increased headwinds for earnings and cash flows. Central bank support of individual high yield issuers will be tested given most do not pose a systemic risk to the economy and almost all carried junk ratings during the longest economic expansion in history.

In the domestic market, which is dominated by investment grade credits, leverage metrics remain elevated, but debt servicing metrics are healthy and refinancing risks do not represent a near-term threat, even amongst the lowest rated names. We feel that highly rated, liquid, short and mid-term corporates are attractive on both an absolute and relative value basis. Although long-term corporates are less attractive on a relative value basis, we are also cognizant of the fact that central banks may eventually flatten yield curves, thus driving down overall long-term corporate yields. The portfolio possesses good liquidity and is structured conservatively. It is well positioned to capitalize on relative value and yield enhancement opportunities.