LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

May 2020

Market Highlights

Credit spread narrowing and credit curve steepening continued through May, as central bank commitments to underpin the credit markets via corporate bond quantitative easing programs took effect. Risk sentiment and liquidity remained constructive for market functioning, however, near record corporate issuance pressured issuer and industry performance. Overall, credit spreads tightened by an average of 5 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 an all-time high.

The Bank of Canada's $10B secondary market Corporate Bond Purchase Program (CBPP) got off to a slow start, with the first few operations purchasing a tiny $26.5M of the $450M maximum par amount, eligible for purchase. The purpose of the CBPP is to support the liquidity and proper functioning of the corporate debt market by alleviating dealer balance sheets through secondary market purchases of corporate bonds. However, with the firm tone in the secondary market, dealer balance sheets were not pressured with excess inventory. Notably, a similar behavior occurred during the first few operations of the Provincial Bond Purchase Program (PBPP), which also saw limited uptake with wide purchase levels. But as the PBPP has progressed, notional purchases have increased to levels more in-line with targets and the market. Despite limited purchases of the CBPP – similar to the experience of the Fed's corporate QE program – the mere adoption of corporate QE programs has improved liquidity and dramatically narrowed credit spreads.

With QE programs focused on five years and under maturities and given improved financing conditions, credit spread curves continued to bull steepen with spreads further out the curve underperforming. For the month, short and mid-term corporate spreads tightened by 9 and 6 bps respectively, while long-term spreads widened by 2 bps. Credit returns were bolstered by an average 2 bps decline of Canada yields across the yield curve. Corporate issuance of $17.8B (68% higher YTD than 2019) of predominately BBB-rated debt pressured lower-rated, long-term debt.

The best corporate spread and absolute performance was reserved for higher-yielding issues in oil and gas (a rebound in energy prices), pipelines (Enbridge, TransCanada and Inter Pipeline), autos (rating agencies appearing more patient with fewer additional downgrades) and industrial services (Waste Mgmt Canada). Lower-rated real estate issuers (Ventas, H&R and First Capital), long term care providers (Sienna and Chartwell), and airports continued to be pressured by COVID-19 containment measures. New issuance weighed on long-term telecom and mid-term insurance issues. Bank debt performed in-line after reporting mixed Q2 earnings as profits were negatively impacted by loss provisions and net interest margin headwinds. Despite the banks' spikes in loss provisions and increases in risk-weighted assets, capital and liquidity remained strong, aided by recent OSFI measures (expected credit loss provisioning, reduction of the domestic stability buffer, and loan treatment under capital adequacy requirement guidelines).

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.