LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

September 2020

Market Highlights

Domestic credit rallied through mid-September amidst positive risk sentiment, moderate primary issuance and a Q2 earnings season which exceeded bleak earnings and revenue estimates. Credit spreads came under pressure heading into quarter-end on rising global COVID-19 cases and US political tensions. For the quarter, spreads narrowed by an average of 23 basis points (FTSE Canada All Corporate Bond Index), with short and mid-term higher-beta issues outperforming. Concerns over BBB-rated credit with negative outlooks also subsided, notwithstanding global potential downgrades (S&P) at near all-time highs.

For the quarter, short, mid and long-term corporate spreads narrowed by 35, 29 and 5 bps, respectively. Short-term corporates continue to be well-bid as evidenced by the lack of purchases through the Bank of Canada's Corporate Bond Purchase Program (limited to < 5-year maturities) at only $15MM for the quarter. The underperformance of long credit was augmented by the underlying Government of Canada yield curve steepening as 2 and 5-year yields fell by 4 and 1 bps and 10 and 30-year yields rose by 4 and 12 bps respectively. The result was short, mid and long-term corporate bond returns of 1.52%, 2.32% and 0.36%, respectively for the quarter (FTSE Canada All Corporate Bond Index).

Across the yield curve, the best spread and absolute performance was reserved for lower-rated, higher-yielding issues in autos (credit rating downgrade concerns easing), oil and gas (Husky Energy), real estate (ex-specific project finance), retail, insurance, pipelines (Inter Pipeline), and non-domestic systemically important banks (Canadian Western, HSBC). Credit card ABS also broadly outperformed as collateral performance has remained steady, due in part to forbearance programs and the Canada Emergency Response Benefit.

Whereas spread retracement was strong across most sectors, airport spreads were pressured due to rating agency downgrades (on a prolonged traffic recovery period), the GTAA receiving temporary relief from their bond covenants, and the general lack of federal government relief measures for airports. Higher-rated, defensive issues in utilities and infrastructure, illiquid project finance, and telecom/cable generally underperformed. The propensity to take on credit risk decreased with longer maturities as the narrowing of the spread between A-rated and BBB-rated credit was greatest amongst short-term issues.

Portfolio Activity

To capitalize on credit curve steepening, the portfolio's exposure to regulated and highly contracted mid and long-term pipeline and utility credit was increased. Shorter-term positions in pipeline and utility issues which had outperformed were sold. The higher relative credit quality bias of the portfolio was maintained.

What Worked in the Quarter

With portfolio holdings concentrated in short and mid-term debt (<10 year), the portfolio benefitted from the bull steepening of the credit curve. Overweight exposures in insurance, integrated energy, auto and senior domestic non-systemically important bank debt outperformed. The portfolio was underweight utilities, infrastructure (no airport exposure) and telecom/cable which underperformed.

What Did Not Work in the Quarter

The portfolio did not have exposure to lower-rated real estate and non-viability contingent capital subordinated bank debt which outperformed along with more volatile risk assets.

Outlook & Strategy

While central bank QE programs (and their implied backstop) have improved sentiment, 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 COVID-related headwinds for earnings and cash flows.

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 absolute and relative value bases. 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, is structured conservatively, and is well-positioned to capitalize on relative value and yield enhancement opportunities.