LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

October 2020

Market Highlights

Domestic credit spreads were steady through October despite headwinds from a surge in domestic COVID cases, equity market volatility and US political uncertainty. The stable credit tone for most sectors was buttressed by constructive earnings reports and reduced supply. Overall, credit spreads widened by an average of one basis point for the month, with short-term higher-beta issues outperforming. The credit curve steepened further as investors cautiously reached for yield and were hesitant to take on additional exposure to lower-rated long-term debt, particularly for those issues with limited secondary market depth.

For the month, short corporate spreads narrowed by 3 bps, whereas mid and long-term corporate spreads widened by 1 and 5 bps, respectively. Short-term corporates continue to be well-bid due to a lack of domestic bank supply in that part of the curve, given their large USD funding advantage, and the backstop provided by the Bank of Canada's Corporate Bond Purchase Program - CCBP (limited to < 5-year maturities). As has been the case, since the CCBP's inception, purchases made though the program's bi-weekly operations remained subdued with only $13M (of $900M available) acquired for the month. Credit curve steepening was augmented by the underlying Government of Canada curve steepening as 2-year yields fell by 1 bp whereas 5, 10 and 30-year yields rose by 4, 10 and 14 bps respectively.

Across the yield curve, the best spread and absolute performance was reserved for domestic bank debt (with outperformance greater for non-systemically important banks and subordinated issues), autos (based on earnings beat), real estate (retail and healthcare), longer-dated utility (generation and distribution) and transportation infrastructure (airports). Airports, despite seeing only a small improvement in traffic trends, outperformed on increased expectations of near-term government support in the forthcoming fall Federal fiscal update. Beyond the aforementioned industries, a number of lower-rated credits that have lagged year-to-date (e.g. Teranet, CI Financial, MCAP) also outperformed in October, as investors reached for yield.

Rising global COVID cases and European lockdown measures pressured commodity prices and weighed modestly on oil and gas producers and pipeline spreads. Retail (all categories) and telecom/cable also underperformed as they served as a liquid BBB proxy for investors wanting to shed risk and similarly, domestic banks reducing levels of lower-rated inventory heading into bank year-end. Relative performance on a ratings basis reflected the cautious market stance with a bias towards higher credit quality with increasing term, where spread widening between A-BBB credit became more pronounced.

Outlook & Strategy

Despite the ambiguity surrounding the outcome of the US election, credit markets have experienced a post-election rally as there is some relief that a Democratic "blue wave" (and the scenario's amplified fiscal and taxation risks) has been avoided. Credit markets have further benefitted from the flattening of sovereign yield curves and central bank commitments to maintain easy monetary policy and QE corporate bond purchase programs until credit conditions improve.

The backstop provided by these QE programs has improved funding conditions and secondary market liquidity, however, the issue remains as to whether liquidity can solve challenging 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.