LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

November 2020

Market Highlights

Domestic credit spreads rallied through November amidst positive vaccine developments, diminished political risk and underwhelming supply. Even the US Treasury's surprise decision to retire the Fed's QE corporate bond purchase program at year-end resulted in only a brief pause to spread narrowing. Overall, credit spreads tightened by an average of 18 basis point during November, with lower-rated, higher-beta issues outperforming.

Short, mid and long-term corporate spreads narrowed by 18, 20 and 17 basis points, respectively for the month. The retirement of the lightly utilized, primarily psychological backstop to the US corporate primary and secondary credit markets (with its focus on under 5-year maturities) had no adverse effects on short-term credit spreads or the slope of the credit curve. In Canada, we feel it is unlikely that the Bank of Canada will prematurely retire the Corporate Bond Purchase Program prior to its May 2021 term end, despite it being similarly minimally utilized.

Given the prospect of an economic rebound following the distribution of coronavirus vaccines, the best spread and absolute performance across the yield curve was reserved for industries and issuers that have been most pressured by the pandemic and/or are higher yielding. This included oil and gas, real estate (retail, healthcare, office), pipelines (augmented by reduced political risk given less likelihood of a entirely Democratic-controlled congress), autos, insurance (cheap relative to bank credit) and transportation infrastructure (airports). Beyond the aforementioned industries, a number of lower-rated laggards year-to-date (MCAP, Sienna Senior Living and Teranet) also outperformed as investors reached for yield.

Market expectations for the federal government to announce substantial relief measures for airports in its Fall Economic Statement were left disappointed. While the government did announce a deferral of 2021 federal ground rents and $500M in funding to support investments in safety, security and transit infrastructure over six years, they made no mention of direct operational funding or zero/low interest rate loans – similar to what has been provided globally. The transit industry is now focused on vaccines and rapid testing to provide positive catalysts to traffic levels, which appear to have bottomed but are recovering slower than even the subdued expectations of the rating agencies.

With increased risk sentiment, high-rated defensive credit in utilities, pension, senior bank debt and securitization generally underperformed. While these industries and instruments still experienced spread narrowing, long-term project finance and public-private partnerships generally saw spread widening irrespective of industry due to an illiquidity-driven discount. Relative performance on a ratings basis reflected risk-taking bias as BBB credit outperformed across the curve.

Outlook & Strategy

Through the pandemic the credit markets have benefitted from the lowering of sovereign yield curves and central bank commitments to maintain easy monetary policy and QE corporate bond purchase programs until credit conditions improve. While the latter backstop improved funding conditions and secondary market liquidity, the issue remains as to whether liquidity can solve challenging economic fundamentals, credit metrics and ultimately, solvency.

We feel risks will remain elevated for speculative grade credit as the lifelines provided by central banks and governments have only forestalled and potentially deepened creditor losses, given headwinds for earnings and cash flows. Although vaccine progress has been substantial, it will not reduce the severe impact of rising COVID cases. However, in the near-term, investors are likely to look past immediate concerns for riskier credits and tolerate deteriorating fundamentals. We also see increased risks that, given the political environment, the Fed's corporate credit facilities will not be easily reinstated should they be required in the event of significant market disruption.

In the domestic market, which is dominated by investment grade credits, leverage metrics remain elevated, but debt servicing metrics are healthy and refinancing risks are not 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 will likely keep a lid on long-term government yields, which will also impact corporate yields.

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