LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

December 2020

Market Highlights

The surge in global COVID cases and equity market volatility in the runup to the US election led to bear steepening of credit curves. Following the election, sentiment shifted as political risk diminished and positive vaccine news intensified. Even the US Treasury's surprise decision to retire the Fed's corporate bond purchase program (Secondary Market Corporate Credit Facility or SMCCF) at year-end resulted in only a brief pause to spread narrowing. Overall, credit spreads tightened by an average of 26 basis point during Q4, with lower-rated, higher-beta issues outperforming.

For the quarter, short, mid and long-term corporate yields fell by 26, 23 and 13 basis points, respectively. Credit curve steepening was augmented by underlying Government of Canada curve steepening. The retirement of the little-used SMCCF, primarily a 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 little-used.

With the prospect of an economic rebound following the distribution of coronavirus vaccines (despite timing being somewhat ambiguous), industries and issuers hardest hit by the pandemic and higher yielding issues had the best spread and absolute performance across the yield curve. Top performing industries were oil and gas, real estate (retail, healthcare, office), pipelines, autos, insurance (cheap relative to bank credit) and transportation infrastructure (airports). With increased risk sentiment, high-rated defensive credit in utilities, infrastructure, pension, project finance, legacy bank deposit notes and securitization generally underperformed. Relative performance on a ratings basis reflected a risk-taking bias as BBB credit outperformed in the investment grade space across the curve.

Portfolio Activity

Capitalizing on credit curve steepening, we increased the portfolio's exposure to regulated utility, telecom and pipeline credit via a reduction of shorter-term domestic bank and telecom positions. The higher relative credit quality bias of the portfolio was maintained.

What Worked in the Quarter

The portfolio benefitted from the bull steepening of the credit curve, given its concentration in short and mid-term debt. The portfolio also benefitted from overweight exposures in outperforming issues of integrated energy, insurance, pipeline, auto and industrial services and from underweight exposures in underperforming issues of utilities, infrastructure, retail, pension, project finance and securitization.

What Did Not Work in the Quarter

The portfolio possesses a relative higher credit quality and did not have exposure to lower-rated real estate, mortgage finance and non-viability contingent capital subordinated bank debt which, along with more volatile risk assets, outperformed.

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 corporate bond purchase programs until credit conditions improve. While QE has created significant liquidity and improved funding conditions, the issue remains as to whether in the longer-term liquidity can solve challenging economic fundamentals, credit metrics and ultimately, solvency.

The default cycle may be long and drawn out for speculative grade credit as the lifelines provided by governments and central banks have only forestalled and potentially deepened creditor losses, given weakened earnings, cash flows, debt structures and terms. Despite weakened fundamentals, speculative grade credit spreads have compressed, resulting in a dichotomy between low market-implied default forecasts and rating agency forecasts for defaults to rise. Agencies expect defaults to approach rates last seen during the credit crisis based on deteriorating credit fundamentals and the rapid growth of speculative, CCC-rated debt (50% YOY in 2020 – S&P).

In the Canadian 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 expect central banks to counter any steepening of sovereign yield curves, which will also limit steepening of credit curves. The portfolio possesses good liquidity, is structured conservatively, and is well positioned to capitalize on relative value and yield enhancement opportunities.