LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

January 2021

Market Highlights

The domestic spread curve flattened – with the decline increasing with maturity – through late January as equity markets rallied and bond yields rose in anticipation of US fiscal stimulus and the possible impact on inflation, despite more troubling economic prospects due to COVID restrictions on consumer activity. Sentiment weakened thereafter as equity market volatility was heightened considering uncertainty over vaccinations and the timing and scope of a fiscal package. Overall, credit spreads tightened by an average of 7 basis points for the month with lower-rated, higher-beta issues outperforming.

Overall, short, mid and long-term corporate yield spreads fell by 3, 8 and 7 bps, respectively for the month. The flattening of the credit spread curve reflected extensions in mid-term maturities of higher beta names, the absence of long corporate credit supply, and the demand for longer duration credit to capitalize on a steeper Canada curve. For the month, Government of Canada 2-year yields fell by 5 bps whereas 5, 10 and 30-year yields rose by 4, 17 and 26 bps, respectively.

TransCanada Energy Corp's decision to suspend the advancement of the Keystone XL crude oil pipeline project given the President's executive order revoking the Presidential Permit in place for the pipeline, was met favourably by both the credit markets and rating agencies. Since 2018, TransCanada and the Alberta government have each made investments of about S1 Billion (which will result in impairment charges); however, with the suspension, about $9 billion of capital needs will be freed up, reducing leverage and funding requirements. The suspension also removed exposure to the very high level of execution risk that the rating agencies had assigned to the project – Moody's returned its outlook for TC Energy to stable from negative following the announcement.

Given the relative strength of energy prices and expectations of reduced debt supply in affiliated sectors going forward, oil and gas (integrated, exploration) and pipelines outperformed across the curve. Insurance also materially outperformed on capital market movements and relative value (attractive versus banks). Positive sentiment also benefitted more cyclical issuers in auto, real estate and financial services. With increased risk sentiment, high-rated defensive credit in infrastructure, utilities, pension and bank debt (across the capital structure) generally underperformed. Transportation infrastructure – i.e. airports, came under further pressure this month as additional international travel restrictions were implemented by the Canadian government and S&P downgraded the credit ratings and kept the outlook on negative for various Canadian airport authorities. Relative performance on a ratings basis reflected risk-taking bias as BBB-rated credit outperformed across the curve.

Outlook & Strategy

Through the pandemic the credit markets have benefitted from the lowering of sovereign yields and central bank commitments to maintain easy monetary policy and market liquidity. The specter of corporate bond purchases contributed to improved funding conditions and secondary market liquidity, despite limited actual purchases. However, there is still the question as to whether excess liquidity can solve persistent challenging economic fundamentals, weak credit metrics, and ultimately, solvency.

The default cycle may be long and drawn out for speculative grade credit as the lifelines provided by central banks and governments have only forestalled and potentially deepened creditor losses, given weakened earnings, cash flows, debt structures and terms. Nevertheless, speculative grade credit spreads have compressed, resulting in a dichotomy between low default expectations implied by the market and forecasts of rating agencies for default rates to rise to levels last seen in the credit crisis given weak credit fundamentals and the rapid growth of CCC-rated debt (having increased by 50% last year).

In the domestic market, which is dominated by investment grade credits, leverage metrics remain elevated, but debt servicing is 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 credits are attractive on both absolute and relative value bases. Although long-term corporates are less attractive on a relative value basis, we are cognizant of the fact that central banks will keep a lid on long-term government yields for the foreseeable future, which will also translate to corporate yields. Overall, the portfolio possesses good liquidity, is structured conservatively, and is well positioned to capitalize on relative value and yield enhancement opportunities.