LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

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Market Highlights

Credit curves bear flattened in February as underlying government yields rose and demand from yield motivated buyers remained strong. Central bank commitments to maintain supportive monetary policies, an improving economic outlook and a constructive earnings season lured credit investors to reach for yield out the credit spectrum. Overall, Canadian credit spreads tightened by an average of 2 basis points for the month with longer-term, lower-rated, higher-beta issues outperforming.

Short Canadian corporate yield spreads rose by 5 bps during February, whereas mid and long-term spreads fell by 2 and 8 bps respectively. Credit spread narrowing was more than offset by the rise of the underlying Government of Canada yield curve as 2, 5, 10 and 30-year yields rose by 15, 45, 51 and 28 bps respectively. The flattening of the credit spread curve is inconsistent with the steepening generally seen in the years subsequent a recession and typically occurs alongside periods of monetary policy tightening or acute pressures in credit. However, given that current monetary policy has kept a lid on government yield curve normalization, all-in yield sensitive investors (pensions, insurance) rushed at the opportunity to lock-in higher corporate long-term yields and flattened the credit curve in the process.

Domestic bank earnings were broadly positive from a credit perspective as earnings and asset quality were strong and capital and liquidity measures remain well above regulatory requirements. Notably, all banks reported lower than expected provisions for credit losses on an improving economic outlook. Despite the optimism, concerns remain over the composition of loan growth (primarily mortgages) and the trajectory of asset quality metrics given the un-precedented quantity of government stimulus and payment relief measures. Funding continues to be a tailwind for bank debt performance as domestic banks capitalize on more favourable funding levels in the US, reducing domestic supply pressures.

The reach for yield was evident in industry performance as lower-rated, higher-yielding issues in oil and gas (aided by energy price strength), real estate, telecom and cable, retail (ex-Alimentation Couche-Tard), pipelines and insurance (life, P&C) outperformed across the curve. Conversely, higher-rated, defensive credit in utilities, securitization (credit card, HELOC), pension (real estate investment vehicles) and domestic systemically important bank debt (across the capital structure) generally underperformed. Autos also underperformed over concerns that semiconductor shortages could dampen the industry's recovery in the near-term. Relative performance across ratings reflected a risk-taking bias as spread compression between A and BBB-rated debt moved well though pre-COVID levels resulting in outperformance of lower-rated credit.

Outlook & Strategy

Through the pandemic the credit markets have benefitted from the decline of sovereign yields and extraordinary monetary and fiscal support. While funding conditions and secondary market liquidity greatly benefitted from policy measures, the issue remains as to whether 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 central banks and governments have only forestalled and potentially deepened creditor losses, given weakened earnings, cash flows, debt structures and terms. Risk that the reopening of the economy may be hampered by further waves of infection or variants that could be more contagious or severe also remain. Despite this backdrop speculative grade credit spreads have compressed to near post credit crisis lows, resulting in a dichotomy between low market-implied default forecasts and rating agencies forecasts for default rates to rise to post credit crisis highs. Rating agencies have pointed to the weak credit fundamentals and deteriorating rating distributions – CCC-rated debt increasing 50% in 2020.

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.