LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

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Market Highlights

Domestic credit curves dramatically bear steepened in Q1 amidst a reflation-trade frenzy. Q1 marked the worst quarterly performance for corporate bonds since 1994 and only the second time since that date that quarterly returns were below -2%. The spike in government yields, drove issuers to bring forward expected issuance, which resulted in near record first quarter supply (the bulk between late February and mid-March), pressuring credit spreads in the process. With supply pressures waning into quarter-end, and tailwinds from an improving economic outlook and a constructive earnings season, credit spreads ultimately tightened by an average of 4 basis points over the quarter with lower-rated, higher-beta issues outperforming.

Short corporate yield spreads rose by 5 basis points during the quarter, whereas mid and long-term corporate yield spreads fell by 7 and 10 bps, respectively. Credit spread narrowing was more than offset by bear steepening of the underlying Government of Canada curve as 2, 3, 5, 10 and 30-year yields rose by 2, 24, 60, 88 and 76 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) have set out to lock-in higher corporate long-term yields, which has flattened the credit spread curve in the process. Relative performance on a ratings basis reflected risk-taking bias as BBB credit outperformed across the curve.

Given the strength of energy prices and expectations of reduced debt supply in affiliated sectors going forward, oil and gas (integrated) and pipelines (TC Energy) outperformed across the curve. Insurance credit also materially outperformed on yield curve steepening and relative value (attractive valuation versus bank credit). Positive sentiment benefitted more cyclical issuers in real estate, retail and financial services. Autos also participated in this cyclical rally until concerns that semiconductor shortages could dampen the industry's near-term recovery, pressured spreads, resulting in middling industry performance. With increased risk sentiment, high-rated defensive credit in infrastructure, utilities, pension and bank debt (across the capital structure) generally underperformed. The transportation infrastructure sub-sector remained under pressure as additional international travel restrictions were implemented by the Canadian government and S&P downgraded the credit ratings and kept their outlook on negative for various Canadian airport authorities. After outperforming for most of the quarter, telecom and cable came under large supply pressures at quarter-end ($3.5B in longer-term bonds) with Rogers spreads coming under acute pressure on its announced intention to acquire Shaw.

Portfolio Activity

To capitalize on credit curve steepening, the portfolio's exposure to telecom, senior domestic bank, infrastructure, insurance and pipeline credit was increased through a reduction in shorter-term positions in domestic bank and telecom debt. The higher relative credit quality bias of the portfolio was maintained.

What Worked In The Quarter

The portfolio benefitted from the bear steepening of the credit curve as it was underweight long-term credit. Overweight exposures in integrated energy, insurance, pipeline and industrial services debt outperformed. The portfolio was underweight utilities, infrastructure, pension and securitization debt which underperformed.

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, retail, hybrid and financial services debt which, along with more volatile risk assets, outperformed. The portfolio was overweight telecom debt which came under supply pressures near quarter-end.

Outlook and Strategy

Credit conditions remain favourable as government and central bank support measures continue to backstop market liquidity. However, there is still the question as to whether excess liquidity can solve stretched credit metrics and ultimately, solvency. The default cycle may be long and drawn out for speculative grade credit as support measures have only forestalled and potentially deepened creditor losses given the share of speculative grade issuers with the weakest ratings (B- to CCC) nears historical highs, leverage is elevated, and debt structures and terms have weakened. Despite this backdrop, speculative grade credit spreads have compressed to post credit crisis lows, leaving the potential for significant spread widening and elevated defaults once economic growth slows toward the longer-term rate or the pace of economic growth is hampered by further waves of infection or variants.

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, is structured conservatively, and is well positioned to capitalize on relative value and yield enhancement opportunities.