LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

April 2021

Market Highlights

Domestic investment grade credit traded cautiously through April as investors wait for more evidence that the recent strength of macro and corporate earnings data is sustainable, before pushing spread narrowing further. For the month, credit spreads were flat, and traded within a four-basis point range. The lack of volatility would typically aid lower-rated, higher yielding credit; however, performance was more idiosyncratic than the recent momentum driven market.

For the month, short and mid-term corporate yield spreads fell by 2 bps whereas long-term corporate yield spreads rose by 2 bps. Credit curve steepening was augmented by steepening of the underlying 2-30's Government of Canada curve as it steepened by 7 bps. With rate volatility subsiding and an expected slowdown in non-financial bond supply due to prefunding, less maturities and lower expected funding deficits, a variety of infrequent domestic and international issuers (airports, financials, special-purpose entities) came to market. While deals were heavily oversubscribed their performance in secondary markets was more subdued.

Heavy airport infrastructure issuance by Heathrow ($950M), Montreal ($400M), Halifax ($150M) and Ottawa ($100M) airport authorities pressured airport spreads which were not helped by an absence of financial support in the Federal budget. The government did come forward with infrastructure project funding and indirect support through low-interest loans being provided to the aviation sector (Air Canada, Air Transat). However, airports are seeking a further moratorium on ground leases and more options for interest free loans as they try to deal with passenger air traffic of 10-20% of 2019 levels (versus 50-60% in the US) and with a full recovery not expected until 2024, at the earliest.

The range of performance between industries and between corporate term spreads was narrow, albeit with some outliers. Given the continued strength of energy prices and deleveraging guidance, oil and gas issuers outperformed. Pipelines benefitted from rating upgrades (Pembina Pipeline) and negative rating outlooks returning to stable (Inter Pipeline). Auto debt outperformed as investors looked past pandemic related supply-chain disruptions. Insurance and bank debt (non-DSIB) performed well on the improving macro backdrop and interest rate movements. In contrast, in addition to airport infrastructure, retail (grocers) and utilities broadly underperformed due to their defensive characteristics. Railways (CN & CP) were by far the worst performing issuers as the dueling bids for Kansas City Southern raised rating downgrade risks for the potential victor.

Outlook and Strategy

Credit conditions remain favourable and we feel that highly rated, liquid, short and mid-term corporates are attractive on both an absolute and relative value basis. Given our forecast for the economic recovery to fall short of expectations, higher-levered credit will widen and a lower and flatter government yield curve will exert some grinding narrowing pressure on higher-grade credit spreads, including longer-term credit, as the market settles into a reach for yield environment. Unlike past reach for yield periods, due to deteriorated credit metrics and the unlikelihood of further monetary or fiscal stimulus, we will see a less momentum driven trade and greater differentiation of spread performance amongst lower rated issuers.

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 high share of speculative grade issuers with the weakest ratings (B- to CCC), elevated leverage and weakened debt structures and terms. 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 domestic economic growth slows toward the longer-term rate and is hampered by slow global economic growth.

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