LORICA
INVESTMENT COUNSEL INC.

Focused Corporate Bond

May 2021

Market Highlights

Domestic investment grade credit spreads were negligibly tighter through May as lower volatility and higher risk markets were overshadowed by lingering concerns over the sustainability of macro data and corporate earnings strength. Credit spreads continued to trade within a narrow range of four basis points, established in April. The lack of volatility would typically aid lower-rated, higher yielding credit, however there was elevated cautiousness due to event, financial and credit rating downgrade risks for various lower-rated issuers.

Absolute corporate returns (the Corporate Universe returned 0.49% in May) were bolstered by the bull flattening of the underlying Government of Canada curve as 5, 10 and 30-year yields fell by 2, 6 and 4 bps respectively. Lighter supply of $7.9 billion (less than half the issuance of May, the year before) as a result of a slowdown in non-financial bond supply (due to prefunding, less maturities and lower expected funding deficits) was supportive of credit.

Second quarter domestic bank earnings were constructive for senior bank credit given continued lighter-than-expected provisioning and strength of non-interest income (wealth management, capital markets) offsetting net interest margin headwinds. Consumer impaired provisions remain a focus as deferral programs have largely come to an end, however guidance was reiterated that provisioning is expected to remain low (normalizing next year). Given expectations for potential shareholder distributions, TLAC requirements and the possible reversal of the Domestic Stability Buffer, we may see pressure on wholesale funding. Supply pressures are most acute in the subordinated non-viability contingent capital (NVCC) space given valuations and expected supply as $5.5 billion in notes that have been called have yet to be refinanced.

On an absolute basis, longer-term credit generally outperformed due to bull flattening of the credit curve. Although the range of spread performance between industries was narrow, there were some outliers. Given the continued strength of energy prices, positive earnings and deleveraging guidance, oil and gas issuers outperformed. Pipelines, in turn, benefitted from reduced counterparty and commodity risks, in addition to well received issuance (Enbridge Pipelines). Also boosted by favourable funding conditions were long-term care providers (Sienna Senior, Chartwell).

Insurance and bank debt (non-DSIB) performed well on solid earnings and the improving macro backdrop. Real estate issuers modestly outperformed on reopening expectations, although gains were given up post-month-end on negative S&P rating outlook changes (RioCan, First Capital). The threat of a multi-notch credit rating downgrade weighed heavily on CN Rail debt due to its leveraged acquisition of Kansas City Southern. Expected supply pressured NVCC and consumer staple (Saputo) issues. Shorter-term retail, telecom, utility and higher-rated auto debt marginally underperformed due to their defensive characteristics.

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 spreads will widen and a lower and flatter government yield curve will exert 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 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, is structured conservatively, and is well positioned to capitalize on relative value and yield enhancement opportunities.