LORICA

Focused Corporate Bond

June 2021

Market Highlights

Domestic investment grade credit spreads tightened in Q2 as lower volatility and investor appetite for risk assets over-shadowed lingering concerns over the durability of the economic recovery and corporate earnings. For the quarter, credit spreads narrowed by an average of 2 basis points and traded within a 5-bps range. Low volatility generally aided lower-rated (BBB-) higher yielding issuers whereas performance for other rating classes was more industry and issuer-specific.

For the quarter, short, mid and long-term corporate yield spreads were narrower by 3, 2 and 1 bps, respectively. Absolute returns were bolstered by the flattening of the Canada yield curve, beyond the 5-year term – 5, 10 and 30-year yields fell by 2, 17 and 13 bps, respectively.

New issuance was lighter through May but lower yields in June attracted a variety of infrequent domestic and international issuers, resulting in record issuance for the month. Supply is still running at a slightly slower pace than last year, with less long-term and domestic bank bail-in issuance, given the relative funding advantage in the US.

Longer-term credit generally outperformed on an absolute basis, due to bull flattening of the yield curve. Given the continued strength of energy prices, positive earnings and deleveraging guidance, oil and gas issuers outperformed. Pipeline holdco debt benefitted from reduced counterparty and commodity risks. Long-term care issuers were boosted by favourable funding conditions. Lower-rated financial services (mortgage finance) and real estate issuers also outperformed on reopening expectations, despite rating agency negative outlook changes. Finally, insurance and bank debt (non-Big 6 leading the pack) performed well on solid earnings, an improving macro backdrop, and relative favourable funding US$ levels, reducing domestic supply expectations.

In contrast, the threat of a multi-notch credit rating downgrade on CN rail debt, due to its leveraged acquisition of Kansas City Southern, weighed heavily on performance. Also, transportation related, airport infrastructure was pressured by heavy issuance, the absence of financial support in the federal budget, and generally longer duration (the credit spread curve marginally steepened in response to flatter government yield curve). Canada-curve flattening also dragged down utility credits given their overall long maturity profile. In the retail and consumer staples space, supply pressured already rich valuations. Telecom debt also marginally underperformed due to expectations of supply from Rogers to fund its acquisition of Shaw.

Portfolio Activity

To capitalize on a back-up in short and mid-term corporate yields, exposure to senior domestic bank and lifeco insurance debt was increased through a reduction in shorter-term domestic bank debt. The higher relative credit quality bias of the portfolio was maintained.

What Worked in the Quarter

Overweight exposures in integrated energy, insurance, senior domestic bank debt, pipeline holdco and transportation infrastructure (407 ETR) issues outperformed. The portfolio had no exposure or was underweight railways, airport, retail, utilities, pension and securitization debt which underperformed.

What Did Not Work in the Quarter

The portfolio possessed a relative high credit quality and was underweight long-term credit which, on flattening of the yield curve, outperformed. The portfolio was not exposed to lower-rated real estate, mortgage finance, hybrid and financial services debt which, along with more volatile risk assets, outperformed.

Outlook & Strategy

Credit conditions have remained favourable given the economic rebound and investors’ aggressive reach for yield. However, cost pressures (eroding profit margins), the gradual withdrawal of monetary and fiscal stimulus, a slowing recovery, and the elevated leverage and weakened debt structure amongst lower rated credits leaves yield spreads of higher risk credits more vulnerable to widening from post credit crisis lows. In the domestic market, which is dominated by investment grade credits, leverage metrics are similarly elevated, but debt servicing metrics are healthy and refinancing risk is not a near-term threat, even for the lowest-rated issues.

Given near-term risks, strong investment grade credit profiles and a relatively flat government yield curve, we expect investors to take a more cautious approach to higher risk credits which will benefit highly rated, liquid credits across the yield curve. Spread pressures will be most evident amongst longer-term, lower-rated, higher-beta and illiquid investment grade credits. The portfolio has good liquidity and is well positioned to capitalize on relative value and yield enhancement opportunities.