Focused Corporate Bond

July 2021

Market Highlights

Domestic investment grade credit spreads widened by 2 basis points over the month amidst broader volatility led by renewed concerns over the Delta variant's effect on economic growth, lingering inflation worries and ramifications for the Fed as it inches towards a taper announcement. The impact was more acute in the US high yield market, which saw a significant drop in issuance and spread widening for the lowest rated credits – B and CCC rated spreads widened 39 and 50 bps, respectively.

For the month, short, mid and long-term corporate yield spreads widened by 3, 3 and 1 bps respectively. Absolute returns were bolstered by the rally in the underlying Government of Canada curve as 5, 10 and 30-year yields fell by 17, 19 and 8 bps respectively. Corporate issuance picked up in July and is now on pace to surpass last year's near record tally, aided by Maple issuance (foreign-issuer, Canadian dollar-denominated bonds) surging to levels ($14.7 billion YTD) not seen since prior to the credit crisis. Demand was driven by investor diversification considerations rather than pricing (home market issuance is slightly cheaper), which encouraged issuance by a number of issuers who have not come to market in more than a decade (e.g., Barclays, National Grid, BNP Paribas).

The month saw a frenzy of M&A activity. Notably, the fight between Pembina Pipeline (PPL) and Brookfield Infrastructure Partners (BIP) to acquire Inter Pipeline (IPL) came to an end. BIP raised its hostile bid and gained the support of IPL's board of directors which had previously backed PPL's $8.5B takeover proposal. In response, PPL terminated their bid altogether which will cost IPL a break free of $350M. Overall the termination was credit positive for PPL as it demonstrated financial discipline and a commitment to credit metrics. Additionally, the break fee reduced leverage and funding needs. Alternatively, IPL and BIP spreads backed up 5-10 bps on the news - the former on increased leverage, structural subordination and asset divesture concerns, the latter on increased financing requirements.

Across the yield curve, the best spread and absolute performance came from issuers in real estate (reopening theme), oil and gas (further deleveraging), pipelines (ex- Inter Pipeline and Alliance Pipelines), insurance (strong core earnings and capital positions) and senior bank debt (non-big six). There was a bias towards higher credit quality moving out the credit curve and as a result long-term utilities and infrastructure (improvement in conditions for traffic recovery at airports) outperformed.

In contrast, telecom spreads came under pressure as results of the spectrum auction were higher than forecast, increasing funding needs (Rogers in particular). Rating actions weighed on the typically placid pension real estate subsidiary space, as DBRS placed OMERS Realty on review with negative implications due to leverage concerns. Finally, subordinated bank debt and retail underperformed due to supply expectations, particularly for retail where a few issuers are focused on consolidation opportunities.

Outlook & Strategy

Credit conditions have remained favourable given the economic rebound and continued easy financing conditions. However, cost pressures, the gradual withdrawal of monetary and fiscal stimulus, a slowing recovery, and the elevated leverage and weakened debt structures amongst lower rated credits leaves yield spreads of higher risk credits more vulnerable to widening from post credit crisis lows. In the Canadian 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 our forecast for the economic recovery to fall short of expectations, higher-levered credit spreads will widen, and a flatter government yield curve will exert narrowing pressure on higher-grade credit spreads, including longer-term credit, as the market settles into a cautious 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, higher-beta and illiquid credits. The portfolio has good liquidity and is well positioned to capitalize on relative value and yield enhancement opportunities.