Focused Corporate Bond

August 2021

Market Highlights

Domestic investment grade credit spreads were flat over the month, having traded in a narrow 2 basis points range. Robust corporate earnings, low issuance and positive risk sentiment coming out of the Jackson Hole Symposium overshadowed concerns over the delta variant's impact on economic and financial conditions. Afghanistan headlines added to volatility in the US credit markets, which at its height, saw high yield primary markets screech to a halt and forced deals to be shelved or issuers offer higher yields to entice investors. Corporate spreads and underlying Government of Canada yields both rose over the month (1 bps, and 3 bps respectively), but enough to wipe out low bond market yields, resulting in negligeable overall returns.

Issuance of $4.3 Billion was the lowest August issuance in six years as US and Euro funding across various tenors remains cheaper for domestic firms to issue abroad. Notably this month, Bell issued a US$1.25 Billion dual tranche offering, split across 10-year ($600 Million) and 30-year ($650 Million) tenors. The deal proceeds, which will be used to fund Bell's acquisition of 3500 MHz spectrum, allowed the company to save 15 and 5 bps relative to a 10 and 30-year domestic offering, respectively. Reduced domestic issuance expectations in turn resulted in a stronger bid for mid and long-term telecom credit.

Q3 Canadian bank earnings all beat consensus estimates largely due to lower loan loss provisions offsetting moderating net interest margin headwinds. With capital ratios remaining well above regulatory minimums, the near-term focus for debt holders is now on the degree of capital deployment (expectations are for $35-40 Billion in CET1 capital surplus to be distributed) when OSFI removes restrictions on share buybacks and dividend increases and its implications for debt capital issuance (NVCC sub-debt, limited recourse capital notes). Bail-in issuance however is expected to be limited as all of the banks have total loss absorbing capacity in excess of the minimum 24% required by November 1st.

Across the yield curve, the best spread and absolute performance came from issuers in telecom (reduced issuance, relative value), real estate (reopening theme), senior bank debt (robust earnings, limited issuance), retail (results were above expectations) and insurance (fixed-floaters). Canadian National Railway recovered some of its recent underperformance as its leveraged takeover of Kansas City Southern (KSU) was thrown into doubt as it failed to pass a key regulatory hurdle.

Alternatively, delta variant concerns weighed on airport debt (Canadian passenger traffic has remained low), securitization (credit card and mortgage receivables) and oil and gas issuers. Auto debt was pressured by production cuts due to chip and part shortages, and inventory depletion of popular models such as SUVs and pickup trucks. Finally, Canadian Pacific Railway bonds were amongst the worst performers as CP appeared better positioned to prevail as the winning bidder for KSU.

Outlook & Strategy

Credit conditions have remained favourable for most industries given the economic recovery and continued easy financing conditions. However, cost pressures, loss of economic momentum, the gradual withdrawal of monetary and fiscal stimulus, and 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 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 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.

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