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Focused Corporate Bond

September 2021

Market Highlights

Rate volatility, softer growth forecasts, persistent cost pressures and risk market selloffs relating to the Evergrande default, Afghanistan withdrawal and US debt ceiling stalemate had little impact on domestic investment grade yield spreads for the quarter, which tightened by 2 basis points across the curve and traded in a narrow 5 bps range. Earlier in the quarter, the steeper Canada curve helped promote more term extension trades in the short and mid-term area However, in September, absolute returns were overwhelmed by bear steepening of the underlying Government of Canada yield curve, as investors reassessed term premiums.

Relatively wide corporate yield spreads as a percentage of all-in yields on a historical basis continue to attract investors. This structural demand buttressed spread widening pressure from an uptick in issuance that is now on pace to surpass last year's near record tally. Maple bond (Canadian dollar-denominated foreign-issuer) issuance surged to levels not seen since prior to the credit crisis, as investors were searching for diversification opportunities rather than attractive pricing – home market issuance was slightly cheaper – which encouraged several issuers who had been absent the market for more than a decade (e.g., Barclays, BNP Paribas) to launch issues.

Across the yield curve, the best spread and absolute performance came from issuers in oil and gas (rising prices, further deleveraging), real estate (reopening theme), pipelines (ex-Inter Pipeline), senior bank debt (robust earnings, limited issuance), insurance (strong core earnings and capital positions) and mortgage finance. Low volatility generally aided BBB-rated credits with the spread between mid-term BBB and A-rated debt narrowing 4 bps over the quarter. Canadian National Railway (CNR) recovered some of its recent underperformance, while Canadian Pacific Railway (CPR) was amongst the worst performers, as CPR emerged victorious over CNR in the competition to acquire Kansas City Southern.

Continued low passenger traffic and expected issuance (Calgary Airport) weighed on airport debt, and telecom/cable spreads (Rogers and Shaw) came under pressure as a result of expected funding needs (due to M&A and the upcoming spectrum auction). 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. 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.

Portfolio Activity

To capitalize on credit curve bear steepening, the portfolio's exposure to lifeco insurance and senior domestic bank 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?

Performance benefitted from the duration and long-term credit underweights as the credit curve bear steepened (higher longer-term yields). The portfolio was overweight exposure in integrated energy, insurance, domestic bank debt (senior and non-DSIB) and pipeline debt which outperformed. The portfolio had no exposure or was underweight, airport, pension, utility and securitization debt which underperformed.

What Didn't Work In The Quarter

The portfolio had relative higher credit quality than the benchmark and did not have exposure to lower-rated real estate, mortgage finance, hybrid and financial services debt which outperformed.

Outlook and Strategy

Credit conditions have remained favourable for most industries given the economic recovery and continued easy financing conditions. However, amongst higher risk credits, cost pressures, loss of economic momentum, gradual withdrawal of fiscal stimulus, elevated leverage, and weakened debt structures leave yield spreads 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 issuers.

Given our forecast for the economic recovery to fall short of expectations, we expect the market to settle into a cautious reach for yield environment. Spreads for higher-levered and illiquid issues will widen, particularly for longer-term issues, as term premiums have increased. Unlike past "reach for yield" periods, we will see less momentum driven trade and greater differentiation of spread performance amongst lower-rated, higher-beta and illiquid credits, due to deteriorated credit metrics and the unlikelihood of additional monetary or fiscal stimulus. The portfolio has good liquidity and is well positioned to capitalize on relative value and yield enhancement opportunities.

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