Focused Corporate Bond

October 2021

Market Highlights

Government and credit yield curves dramatically flattened in October as the market aggressively repriced Bank of Canada rate policy expectations on hawkish guidance. Over the course of the month, rate hike expectations shifted from one rate hike by the middle of next year to four. Notably Fed fund futures were pricing in one rate hike over the same period. The shift in forecasts caused two-year yields to rise by 56 basis points, the largest monthly move since 2002. However, generally positive risk sentiment has benefitted credit, causing yield spreads to narrow by 4 bps on average, with the spread and rating curves marginally flattening.

For the month corporate bond yields moved higher, with short, mid, and long-term yields rising by 41, 29 and 2 bps respectively. Credit curve flattening was driven by flattening of the underlying Government of Canada yield curve as 5, 10 and 30-year yields rose by 40, 21 and 1 bps, respectively. Despite a flatter credit curve providing less compensation for term risk, long-term corporate spreads outperformed, aided by long bond yields remaining relatively steady and reduced supply expectations of long-term provincial debt on improved fiscal forecasts.

Apart from rate volatility, event risk also impacted numerous domestic issuers during the month. The most headline grabbing event was the Rogers boardroom dispute which weighed on the credit, which was already lagging due to heavy financing requirements for the Shaw deal and the recent spectrum auction. Notably, S&P downgraded Rogers' governance score and kept the rating on credit-watch negative as the dispute increased execution and integration risks for the Shaw deal. Inter Pipeline suffered a more negative fate, as its credit rating was downgraded by DBRS and S&P on news that Brookfield Infrastructure Partners was increasing leverage by tacking on $1.425B in acquisition financing. M&A news also impacted Cominar REIT, which agreed to be acquired and taken private by a consortium that intends to sell assets to fund a portion of the transaction but have yet to clarify the treatment of existing unsecured debt.

Across sectors, relative performance was not impacted by the potential impact, either positive or negative, from higher rates. Outperforming sectors included: oil and gas – continued energy price strength and deleveraging guidance; pipelines – reduced volume and counterparty risk (ex Inter Pipeline); telecom – supply overhang concerns subsiding; retail – limited supply, and insurance – relative value to banks. Illiquidity discounts hit long-term project finance deals, i.e., generation and transportation; supply pressures weighed on securitization: auto loans, commercial and real estate secured lines of credit; autos lagged on lower sale forecasts due to supply chain disruptions; and more defensive, higher-rated, short-term senior bank and pension debt underperformed on positive risk sentiment. Infrastructure transportation performance was a mixed bag with 407 International, BC Ferries and larger airport issuers (GTAA, ADM, VAA) outperforming whereas smaller airport spreads were pressured by the Calgary Airport Authority's $2B, six tranche fifteen to forty-year deal, which became the largest inaugural bond offering by a Canadian issuer.

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, the market will settle into a cautious *reach for yield* environment. Higher-levered and illiquid credit spreads will widen, particularly for longer-term credit, as term premiums have increased. Unlike past *reach for yield* periods, we expect to see less momentum driven trade and greater differentiation of spread performance amongst lower rated, higher-beta and illiquid issues due to tighter credit conditions and the unlikelihood of further 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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