LORICA

Focused Corporate Bond

November 2021

Market Highlights

Market tone through most of November was constructive for Canadian investment grade credit as yield spreads ground tighter on subdued volatility despite primary supply hitting a November record. Tone shifted dramatically near month-end however, as Powell's hawkish pivot followed by the emergence of Omicron battered risk assets, increased market volatility, and reduced liquidity (magnified by US Thanksgiving). For the month, domestic grade corporate spreads widened by an average of 8 basis points with credit curve flattening. Shorter-dated lower beta issues underperformed as investors enlisted the most liquid areas of the market to reduce credit exposure into widening yield spreads.

During November, short, mid and long-term corporate spreads widened by 10, 9 and 5 bps respectively. Absolute returns were bolstered by lower underlying Government of Canada yields as 2, 5, 10 and 30-year rates declined by 9, 10, 12 and 13 bps respectively on safe-haven flows. Prior to the Omicron headlines, headwinds from a higher and steeper government yield curve coupled with record November corporate issuance of $13.5B could not deter further domestic credit spread narrowing as corporate demand remained strong and rising overall yields were not expected to pressure credit metrics for domestic issuers. The opposite was true in the US High Yield market, which had been lagging prior to the emergence of Omicron due to the negative impact of rising rates on sentiment, fund flows, refinancing activity, and margins. High Yield weakness was visible with yield spreads widening 47 bps over the month and overall yields rising for twelve consecutive sessions – the longest losing streak in the last six years.

Across the yield curve, the best spread and absolute performance came from issuers in long-term project finance deals (generation and transportation) and airports. The former was aided by a lack of trades (securities are generally illiquid), while the latter benefitted from investor duration needs arising from the December 1st index extension, despite travel restrictions concerns overhanging the sector. Longer term, higher rated issues in utilities (electric and gas), financial services and railways (CN Railway) also outperformed. Notably, CP Railway performed in line with the broader corporate sector despite raising C$10.6B across multiple tranches (>C$40B in orders) in the US and Canada to fund the Kansas City Southern acquisition. In the short-term area, autos outperformed due to S&P's positive outlook changes for GM and Ford, resulting in the major auto firms (except Nissan) having either stable or positive outlooks at the rating agency.

With liquidity conditions strained in the final days of the month, investors looked to liquid corporate proxies to manage corporate exposure. As a result, legacy senior bank and telecom debt marginally underperformed. Rogers was the worst performer of the telecom group, its performance impacted by Moody's having concluded that its governance situation was materially credit negative. Oil and pipeline names also came under pressure as energy prices retreated. Generally, investor preference was to reduce credit risk with duration leading to BBB-rated credit outperformance in the short-term area and underperformance further out the curve.

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, elevated leverage, and weakened debt structures amongst lower rated credits leaves spreads of higher risk credits more vulnerable to widening from post credit crisis lows. Leverage metrics in the Canadian market, which is dominated by investment grade credits, are similarly elevated, but debt servicing metrics, even for the lowest rated credits, are healthy and refinancing risk is not a near-term threat.

Given our forecast for the economic recovery to fall short of market expectations, we anticipate that the market will settle into a cautious reach for yield environment. Credits that are higher-levered and have weak liquidity profiles will see yield spread widening, particularly for longer-term credit where term premiums have notably increased. Unlike past "reach for yield" periods, due to deteriorated credit metrics and less likelihood of further monetary and fiscal stimulus, we expect to see less momentum driven trading 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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