Focused Corporate Bond

December 2021

Market Highlights

Government and credit yield curves significantly flattened during the quarter as investors initially increased rate hike expectations which pushed up short-term yields substantially, while in December investors reduced growth expectations which pushed down real long-term yields. Positive market tone and subdued volatility for the balance of the quarter was constructive for domestic investment grade credit spreads. However, Omicron headlines, pressured spreads wider into year-end resulting in spread widening by an average of 7 basis points for the quarter, with spread and rating curves marginally flatter.

For the quarter, short, mid corporate yields rose by 45 and 11 bps respectively, whereas long-term corporate yields moved lower by 25 bps. Credit curve flattening was driven by underlying Government of Canada yields, index extension needs coinciding with reduced long-term provincial supply, and pressure on shorter-dated, lower beta debt which provided liquidity amidst the volatility and illiquid year-end period.

Across the yield curve, the best spread and absolute performance came from issuers in utilities (electric and gas), telecom (supply overhang and Rogers' governance concerns subsiding), insurance (lifeco & P&C), financial services, retail (grocers) and securitization (credit card receivables and mortgages). Illiquidity discounts widened the spreads of long-term project finance deals (generation and transportation), Omicron concerns weighed on real estate issuers (larger retail focused REIT's), and senior and subordinated bank debt of the big six were pressured as investors looked to the most liquid corporate sector to manage near-term corporate exposure. Infrastructure transportation performance was a mixed bag with 407 International and larger airport issuers (GTAA, ADM, VAA) outperforming whereas smaller airport spreads were pressured by Calgary Airport Authority's $2B multi-tranche deal, which became the largest inaugural bond offering by a Canadian issuer.

Portfolio Activity

Given corporate spread widening to the highest levels of the year, the underweight in corporate credit exposure (on a duration-weighted basis) was reduced through the purchase of senior bank debt and the sale of auto debt which had outperformed. The duration, yield curve, sector and high credit quality biases of the portfolio were maintained.

What Worked In The Quarter

The portfolio benefitted from sector and issuer composition as it had an overweight of outperforming issues of telecom, insurance and senior debt of domestic non-DSIB banks. As we forecasted, twenty-year credit outperformed relative to other long-term tenors as the ten to twenty-year credit spread curve flattened whereas the twenty to thirty-year credit spread curve steepened. The portfolio's had 4 bps of credit yield spread widening versus 7 bps for the benchmark.

What Didn't Work In The Quarter

The portfolio was positioned conservatively, with a short relative duration and an underweight in long-term credit in recognition of near-term upside risks to breakeven inflation rates and nominal yields. Reduced growth expectations led to lower real long-term yields and resulted in a flattening of the credit yield curve.

Outlook & Strategy

Credit conditions have remained favourable for most industries given the economic recovery and continued easy financing conditions. However, a variety of factors including cost pressures, loss of economic momentum, the withdrawal of monetary and fiscal stimulus, elevated leverage, and weakened debt structures amongst lower rated credits, as well as the risk of central bank policy errors, leave spreads of higher risk credits more vulnerable to widening from near post credit crisis lows. In the Canadian market, which is dominated by investment grade credits, leverage metrics are 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 reliant on easy financing conditions will see yield spread widening, particularly longer-term credit where term premiums are low. Unlike in past "reach for yield" periods, due to deteriorated credit metrics, reduced monetary and fiscal stimulus, and elevated event risk, 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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