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Focused Corporate Bond

January 2022

Market Highlights

Credit markets came under pressure in January as equity market volatility, monetary policy uncertainty and poorly received earnings bruised market sentiment. The risk-off tone was most acute in the US high yield markets which saw risk premiums rise and issuance struggle on lower demand in the latter part of the month. Canadian investment grade corporate yield spreads widened by 10 basis points on average during the month, compared to US investment grade and high yield spreads which widened by 14 and 59 bps, respectively. With investors taking a cautious stance, higher-beta, higher-yielding issues generally underperformed across the curve.

In January, short, mid and long corporate yield spreads widened by 11, 12 and 9 bps, respectively, moving spread levels above their five-year averages. Short and mid-term credit were the worst performers, as investors used the sale of short and mid-term bonds, along with cash, to fund purchases of new issues. Issuance was heavy ($11.2B versus $6.5B last January), particularly early in the month, as issuers pulled issuance forward, hedging against expectations of higher rates. Spread weakness was augmented by the upward shift in the Government of Canada yield curve as 2, 5, 10 and 30-year yields rose 33, 39, 36 and 38 bps, respectively.

Across the yield curve, the best performance came from issuers in oil and gas (on continued strength of energy prices), securitization (AAA-rated credit card receivables), financial services (mortgage insurers) and more defensive issues in utilities, legacy senior bank debt and long-term project finance deals (health and transportation). Airport performance was mixed, with airports more reliant on domestic traffic (Calgary, Halifax, Ottawa, Winnipeg) outperforming those with a higher dependence on international traffic (Toronto, Montreal).

Given increased risk aversion, higher-beta and lower-rated issues across all categories of real estate, autos and hybrid debt underperformed across the curve. Volatility in real estate issuers also pressured the pension space through their real estate subsidiaries. Heavy domestic and foreign supply, as well as concessionary pricing weighed on non-viability contingent capital bank debt and, to a lesser extent, bail-in debt. In a similar vein, pipelines lagged oil and gas outperformance as near-term bond supply expectations overshadowed energy price strength and reduced counterparty risk. Finally, mid-term telecom came under pressure at month-end due to expectations of a large Rogers US$ hybrid issue.

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, and tighter monetary policy make 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.

In a tightening cycle environment, we would typically expect overall corporate credit spreads to narrow and corporate credit curves to steepen due to an improving macroeconomic backdrop. However, corporate yields may prove more volatile this tightening cycle, given the high level of inflation and the potential for a sharp increase in policy rates. Financing “technical” also favour credit curve steepening as the relative attractiveness of long-term US$ swapped equivalent credit spread levels, attractive to US dollar issuers, has narrowed. Consequently, the probability of Canadian issuers accessing the domestic market in lieu of the Yankee market has increased, resulting in supply and new issue concessions potentially weighing on secondary market long-term corporate spreads.

With gradual economic improvement, but continued overhang of the pandemic, and most importantly tighter monetary policy, we anticipate that credit markets will settle into cautious reach for yield behaviour. Credits that are higher-levered and reliant on easy financing conditions will see yield spread widening, particularly those with longer maturities where term premiums are low. We expect to see 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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Cidel Asset Management