LORICA

Focused Corporate Bond

February 2022

Market Highlights

Early in February, credit spread stability was evident as fears regarding the impact of rate-hikes on credit eased due to healthy corporate fundamentals and overall attractive yield levels for investors. However, geopolitical risks set the tone thereafter as mounting tensions between Russia and Ukraine resulted in a flight to quality and an increase in liquidity risk premiums. Volatility increased, stemming from both the escalating military and humanitarian crisis and the macroeconomic and credit implications of disruptions to international money flows and commodity supplies.

Globally, credit was pressured across the yield curve, with US and European speculative grade primary markets grinding to a halt. Risk repricing and a tightening of financing conditions for speculative grade issuers, that was evident through most of February, began to ease at month-end. In Canada, primary investment and high yield markets remained active, albeit aided by increased concessionary pricing. Overall, credit spreads widened by 15 bps on average for the month. Higher government yields exacerbated the credit spread weakness, resulting in the rise of short, mid and long-term corporate yields of by 23, 22 and 18 basis points, respectively during February.

For domestic credits, commodity disruptions have had the most immediate direct impact, with higher energy prices acting as a tailwind for commodity producer earnings. Broader concerns that commodity disruptions may slow economic growth or erode profits for industries that are energy intensive or rely on discretionary consumer spending remain.

With investors taking a cautious stance, defensive and higher-rated issues generally outperformed across the yield curve. Utilities (CU Inc, Enbridge Gas, Fortis BC), legacy senior bank debt and infrastructure transportation were top performers. The latter was aided by the announcement that the federal government was easing border restrictions and travel advisories, benefitting transborder and international traffic at airports which comprised the majority of pre-pandemic flows for the largest Canadian airports. Rising energy prices resulted in integrated energy producers (Suncor, Cenovus) to outperform on the anticipation that higher earnings will accelerate their pace of deleveraging.

Negative risk sentiment resulted in the underperformance across the yield curve of lower-rated, higher beta issues across all categories of real estate, subordinated bank debt, autos, retail and hybrid debt. Volatility amonst real estate issuers also pressured the pension space through their real estate subsidiaries. A poorly received Rogers US$ hybrid deal – the coupon was increased, and the deal was not upsized – pressured telecom credit, given future issuance to cover some or all of Rogers $13B bank bridge facility. However, US$ BCE (30-year) and Telus (10-year sustainability-linked bond) new issues were well received, launching at spread levels that were through equivalent domestic levels.

Outlook & Strategy

Geopolitical risks and rate volatility have tightened easy financing conditions and hurt risk sentiment. The risk-off tone has been most acute in the speculative grade markets which has seen risk premiums rise and issuance struggle on lower demand, particularly for issuers that have weak business profiles and those with longer maturities where term premiums are low. In the Canadian market, which is dominated by investment grade credits, leverage metrics and debt servicing metrics, even for the lowest rated credits, are healthy and refinancing risk is not a near-term threat.

With gradual economic improvement, but continued overhang of geopolitical risks, the pandemic and most importantly tighter monetary policy, we anticipate that credit markets will settle into cautious reach for yield behaviour. 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 above risks. 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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