Focused Corporate Bond

March 2022

Market Highlights

Corporate credit was pressured in Q1 amid heightened rate volatility, tighter financing conditions and elevated geopolitical risks, which prompted a flight to quality and an increase in liquidity risk premiums – credit spreads widened by an average of 27 basis points during the quarter. Higher government yields combined with wider credit spreads to generate the worst quarterly corporate bond performance in forty years as short, mid and long-term corporate yields rose by 153, 146 and 96 bps, respectively.

Globally, strains were most evident in US and European primary markets as speculative grade issuance ground to a halt, only beginning to ease in March. However, in Canada, primary investment grade and high yield markets remained active, albeit aided by concessionary pricing. Issuance was up by 40% YTD and March issuance of $29.5B set a monthly record, driven by increased Canadian bank supply.

With investors taking a cautious stance, defensive and higher-rated issues outperformed across the yield curve. Utilities, infrastructure transportation and legacy senior bank debt were top performers. Also outperforming were integrated energy producers given the anticipation that higher earnings will accelerate their pace of deleveraging, and telecoms, after the supply overhang from Rogers was cleared and $US issuance from BCE and Telus, at spread levels that were through domestic levels, aided sentiment.

Negative risk sentiment resulted in the underperformance of lower-rated, higher beta issues of real estate, subordinated bank debt, autos, retail and hybrid debt, across the yield curve. Volatility amongst real estate issuers also impacted the pension space through their real estate subsidiaries. Record issuance from banks pressured senior bail-in debt and other short-term financial debt in insurance, services and securitization.

Portfolio Activity

The portfolio was structured for higher yields with short relative duration, and a steepening credit curve with liquid, higher-rated credits. Coupons were reinvested into existing higher-yielding positions.

What Worked in the Quarter

The portfolio benefitted from its sector and issuer composition, which experienced less credit spread widening than the market, given an overweight of outperforming issues of integrated energy producers, telecom and pipelines. The portfolio had no exposure to lower-rated, higher beta issues in real estate, subordinated bank debt, autos, retail and hybrid debt which underperformed on risk aversion. The portfolio was slightly short duration which benefited the portfolio as yields rose.

What Didn't Work in the Quarter

The rise and bear-flattening of the Canada yield curve dominated the move of corporate yields. Consequently, the portfolios conservative positioning with overweights of short and mid-term debt in lieu of long debt was negative for performance, given the bear flattening of corporate yield curves.

Outlook & Strategy

Tightening monetary policy, geopolitical risks and ongoing COVID issues have hurt risk sentiment. Reactions have been most acute in the speculative grade markets which have seen risk premiums rise and issuance struggle on lower demand, particularly for issuers with weak business profiles and 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.

Given the macro backdrop and event risks, we anticipate that credit markets will remain in a cautious reach for yield environment. During a tightening cycle, corporate credit spreads typically narrow and credit curves steepen due to an improving macroeconomic backdrop. However, corporate yields may prove more volatile this tightening cycle given the plethora of 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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