LORICA

Focused Corporate Bond

May 2022

Market Highlights

Credit markets were volatile through May amidst mixed market sentiment. The impact of monetary policy actions was the largest contributor to market uncertainty, as the Bank of Canada and Federal Reserve both delivered on their forward guidance by raising overnight rates by 50 basis points, thereby contributing to the headwinds of higher rates and inflation facing the economy. Primary issuance was constrained due to the volatility, as elevated new issue concessions were required for investor engagement. However, with reduced supply, relatively strong earnings releases, healthy credit metrics and high-all in yields, credit spreads held in relatively well given their appeal on a yield carry basis. For the month, the investment grade credit spread curve bear flattened with short, mid and long-term credit spreads widening by 11, 8 and 3 bps respectively. Including the bear steepening move of the Government of Canada yield curve, all-in corporate yields for short, mid and long-term credit yields rose 12, 10 and 8 bps respectively.

From a credit perspective, Q1 earning releases highlighted the unease over business activity given higher inflation and funding-cost pressures. Any positive sentiment that stemmed from strong consumer demand and higher revenue growth was overshadowed by outlook concerns over margin compression due to inflation pass-through and a less robust economic backdrop. The most acute reporting was by retailers, although transportation, capital goods and utilities also saw notable margin pressures. Despite a more challenging operating environment, leverage and interest coverage remained at the strongest levels in a decade due to substantial refinancing activity and deleveraging efforts, amongst various industries, during the low interest rate environment through the pandemic.

The interplay of robust activity and higher rates was also evident in domestic Q2 bank earnings. Loan growth was strong as credit card volumes broadly picked up due to discretionary spending, after being subdued during the pandemic due to paydowns. Commercial lending also rose as there was a rebound in credit facility utilization related to working capital, capital investment needs and, more ominously, issuers not tapping primary markets given the volatility of rate and credit markets. As loan growth outpaced deposit growth, risk weighted assets and regulatory capital were pressured, resulting in increased wholesale funding, which consequently pressured secondary spreads and net interest margins.

Utilities (distribution and generation) and infrastructure credits were amongst the top performers. Telecom outperformed across the curve given relative value and the Competition Bureau's announced formal opposition to the Shaw/Rogers transaction, which may trigger special mandatory redemptions on recently issued bonds. Cenovus' early redemption notice, as it deleverages amidst high energy prices, tightened integrated energy spreads as investors sought similar issues, expecting similar outcomes. Finally, legacy senior bank deposit notes saw buying interest as a liquid defensive corporate proxy.

Real estate issuers underperformed as investors adopted a more cautious view of the industry given higher mortgage rates and retail headwinds. Auto finance debt was pressured due to persistent production disruptions and financing needs. Finally, new issue concessionary pricing marginally weighed on domestic bank senior bail-in and subordinated debt, securitization, pipelines and insurance issues.

Outlook & Strategy

Concerns over the impact of inflation and tightening monetary policy on the economy have weakened risk sentiment. The impact has been most acute in the speculative grade markets which have seen risk premiums rise and issuance struggle on lower demand. 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 investors will cautiously look to credit as a source of attractive yield carry. 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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