



Focused Corporate Bond

June 2022

Market Highlights

Corporate credit came under further pressure in the second quarter as headwinds from persistent inflation and aggressive monetary policy weighed on market sentiment. Primary issuance was constrained due to market volatility, as elevated new issue concessions were required for investor participation, resulting in repricing of secondary curves wider. However, domestic investment grade spreads held in relatively well, given their appeal on a yield carry basis from high all-in yields, their reduced supply, and healthy credit metrics.

For the quarter, Canadian investment grade spreads widened by an average of 26 basis points versus 41 and 248 bps in the US investment grade and high yield markets, respectively. The investment grade credit spread curve bear flattened with short, mid and long-term credit spreads widening by 31, 28 and 21 bps respectively. Combined with the bear flattening move of the Government of Canada yield curve, all-in corporate yields for short, mid and long-term credits rose by 118, 104 and 99 bps respectively.

From an industry perspective, defensive and higher-rated issues generally outperformed across the yield curve. Utilities (distribution and generation) and infrastructure (toll roads and airports) were top performers. High energy prices and Cenovus' early redemption notice (as it accelerates deleveraging) aided integrated energy producer issues. Real estate issuers underperformed as investors adopted a more cautious view of the industry given higher mortgage rates and retail headwinds. Auto finance debt also came under pressure due to persistent production disruptions and financing needs. Finally, new issue concessionary pricing weighed on domestic bank (across the capital structure), securitization, pipeline and insurance issues.

Portfolio Activity

Given higher yields and inversion of the short and long-term Government of Canada yield curve, proceeds from Cenovus' early redemption (at a premium to secondary levels) together with excess cash were invested into three-year Thomson Reuters debt, which has strong and improving fundamentals, no near-term supply concerns and potential ratings upside.

What Worked in the Quarter

Performance benefitted from sector and issuer composition, which resulted in less credit spread widening than the market. The underweight in BBB-rated debt and overweight in outperforming issues of integrated energy producers and energy distribution were both positive factors. There was also no exposure to lower-rated, higher beta issues in real estate, autos and hybrid debt which underperformed on investor risk aversion. Finally, the portfolio was short duration which benefitted relative performance as yields rose.

What Didn't work in the Quarter

The portfolio was conservatively structured with concentrations of short and mid-term debt in lieu of long-term debt which was negative for performance given the bear flattening of corporate yield curves.

Outlook & Strategy

Concerns over the impact of inflation and tighter monetary policy on the economy have weakened risk sentiment. The impact has been felt most acutely 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 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. However, given the rapid increase in rates, persistent inflation and macroeconomic downside risks, corporate yields may prove more volatile this tightening cycle than prior episodes. We therefore expect to see a 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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