Focused Corporate Bond

July 2022

Market Highlights

Credit markets rallied though July despite a challenging economic outlook. Macro concerns were overshadowed by improved financing conditions, healthy corporate credit metrics, a constructive earnings season and significantly lower sovereign yields, the latter of which increased the appeal of corporate debt on a yield-carry basis. For the month, the investment grade credit curve “bull flattened”, with significant outperformance in the mid part of the curve – short, mid and long-term yields fell by 28, 60 and 48 basis points respectively. With improved sentiment, lower-rated, higher-beta debt generally outperformed across the yield curve.

A marked improvement in financing conditions relative to recent months was evident in Canada and the US as new issue concessions fell and oversubscriptions of new deals rose. Given the rally in sovereign yields, 10-year funding costs for a domestic non-financial A and BBB-rated issuer fell by 88 and 100 bps, respectively on an all-in yield basis, from their peaks in mid-June. Given favourable rates and the fact that short-term issuance from domestic banks has been placed in global markets wherever more attractive funding levels were available, we expect to see a significant increase in non-financial issuance (18% YTD versus 46% last year) and in the average term to maturity (10 years YTD versus 15.4 last year), which will likely weigh on long-term corporate spreads.

Q2 earning releases held up better than expected, however earnings and revenue forecasts have been lowered as profit margins face intensifying pressures, given that cost inflation and supply-chain disruptions have not abated. From a credit perspective, earning results were largely neutral despite a more difficult operating environment; and leverage and interest coverage remained near the strongest levels in a decade due to substantial refinancing activity and deleveraging efforts during the low interest rate environment of recent years. The generally negative economic outlook did however, effect credit risk premia for the lowest rated tranche of high-yield credit (CCC) which underperformed higher-rated classes of speculative grade debt.

From an industry perspective, telecom outperformed across the curve given relative value, positive earnings and further hurdles in completing the Shaw/Rogers transaction (which may trigger special mandatory redemptions on recently issued bonds). Pipelines similarly outperformed given relative value versus utilities and commitments to deleveraging. Oil and gas continued to outperform amidst high energy prices and potential early call redemptions. Alternatively, concerns over falling real incomes and a heavily indebted consumer weighed on retail, credit card receivables, financial services and retail oriented real estate issuers. Subordinated bank debt underperformed due to supply pressures. Finally, auto finance debt was pressured due to ongoing production disruptions, financing needs and margin headwinds.

Outlook & Strategy

Sharply tighter monetary policy and persistent inflation have increased the risks for an economic downturn. The risk 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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