Focused Corporate Bond

September 2022

Market Highlights

Despite the plethora of headwinds facing the corporate bond market, including mixed macroeconomic data, sovereign yield curve inversion, tightening financing conditions, and most importantly, rising yields, credit spreads narrowed modestly through August as investors speculated that healthy corporate credit metrics would shield corporate bonds. An inflection point came in September though as persistently high inflation led the Fed and the Bank of Canada to reiterate that containing inflation was their top priority, thereby increasing the likelihood that their aggressive policy would result in a recession. Negative market sentiment was further exacerbated by the UK debt-funded fiscal package and associated Gilt selloff. Repricing of credit risk premia was most notable amongst the lowest rated tranche of high-yield credit as spreads of CCC-rated debt surged to over 1000 basis points, a level typically associated with distress.

For the quarter, Canadian investment grade yield spreads widened by an average of 8 bps with credit curve bear flattening as short, mid and long-term spreads widening by 8, 10 and 4 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 61, 20 and 5 bps respectively.

From an industry perspective, oil and gas continued to outperform mainly due to persistent high energy prices; Suncor's tender offer for outstanding debt, resulting from the acceleration of its deleveraging program, was also supportive. Pipelines similarly outperformed as investors viewed the sector's deleveraging commitments and relative value versus utilities favourably. Retail issues outperformed on the back of heavily oversubscribed new issuance, highlighting the scarcity of retail product. In a similar vein, senior domestic bank debt was supported by reduced supply expectations. Alternatively, concerns over falling real incomes and a heavily indebted consumer weighed on financial services and retail oriented real estate issuers. Insurance debt underperformed due to supply pressures. Finally, lower-rated auto finance debt came under pressure due to ongoing production disruptions, financing needs and margin headwinds.

Portfolio Activity

Given higher yields and inversion of the sovereign yield curve, proceeds from Suncor's tender offer (at a significant premium to secondary levels) together with excess cash were invested into three-year senior domestic bank debt, which provides good relative value amidst reduced supply expectations.

What Worked In the Quarter

Performance benefited from industry and issuer composition, which resulted in less credit spread widening than the market. The overweight in outperforming issues of integrated energy producers and senior domestic bank debt were also positive contributors. There was no exposure to lower-rated, higher beta issues in real estate, autos and hybrid debt which underperformed. Additionally, the portfolio was short duration which benefited relative performance given the rise in yields.

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

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. 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 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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