Focused Corporate Bond

August 2022

Market Highlights

Domestic credit spreads remained steadfast amidst a shift higher in yields, mixed macroeconomic data and Fed Chairman Powell's hawkish speech at Jackson Hole. For the month, investment grade credit spreads traded in a range of 6 basis points and ended the month 3 bps narrower, reflecting the expected limited impact that rising funding costs and an uncertain economic outlook will have on generally healthy corporate credit metrics. Additionally, non-financial bond supply has been underwhelming which has reduced the pressure on markets from concessionary pricing of new issues. Repricing of credit risk in lower-rated credits which are most vulnerable to weakening economic and financing conditions, was notable however, with spreads of CCC-rated debt widening by 70bps to over 1000bps, a level typically associated with distress.

For the month, short, mid and long-term credit spreads narrowed by 3, 0 and 6 bps respectively. Long bond spread outperformance reflects an appetite for long product (issuance in this term is primarily non-financial) amidst a dearth of non-financial issuance (so far, a fifth of annual issuance versus half for all of last year), as issuers unaccustomed to higher yields have utilized credit lines in lieu of tapping primary markets. The demand for long bonds was evident in August, as the $3.6B of corporate long corporate supply – the largest monthly long-term issuance this year – did not pressure long-term credit spreads. Overall, absolute returns for credit were driven by the bear flattening of the underlying Government of Canada curve as 5, 10 and 30-year yields rose by 67, 51 and 26 bps respectively. Accounting for the flattening of the government and credit spread curves, the yield differential between BBB-rated 5 and 30-year debt closed the month at 42 bps, the narrowest level in more than a decade.

From a credit perspective, domestic Q3 bank earnings were mixed with higher provisions and weaker capital markets activity offset by rising net interest margins, robust loan growth and continued strong capital levels. However, given the macroeconomic uncertainty, expectations are for the pace of loan growth, particularly residential, to slow and provisioning to rise to more to normalized levels. Notably, allowances for credit losses are well above pre-pandemic levels providing some cushion going forward. Given Canada's funding environment and relatively less favourable funding levels versus the $US (15-20 bps cheaper to issue 3-5 year in the US), domestic issuance will slow from the record levels earlier this year, which will be a tailwind for spread narrowing.

Across the yield curve, lower-rated, higher-beta debt generally outperformed. Retail issues outperformed on the back of a well received dual tranche $800M offering from Loblaw, which highlights the scarcity of retail product. Oil and gas continued to be amongst the top performers amidst high energy prices and potential early call redemptions on deleveraging efforts. Real estate issuers saw speculative demand, as investors were looking for retracement of relative underperformance year to date, despite significant headwinds. Also, long pipelines and telecom outperformed, given their relative value versus utilities. Alternatively, public private partnerships underperformed as their illiquidity discount grew. Supply pressures weighed on insurance and regional bank credit, and lower-rated auto debt underperformed due to ongoing production concerns and financing needs.

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 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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