Focused Corporate Bond

October 2022

Market Highlights

Market volatility returned close to early pandemic levels as investors struggled to interpret economic data and in-turn monetary policy. The economic news was not convincing either way – weak housing and retail sales, but strong labour markets and services demand. More importantly, inflation remained stubbornly high. As a result, domestic credit markets came under pressure in October as the rate volatility, monetary policy uncertainty and declining liquidity going into bank year-end bruised market sentiment. Reduced liquidity, primary issuance and associated yield concessions weighed on secondary yield spreads of affected issuers and industries. Canadian investment grade corporate yield spreads widened by 7 basis points on average during the month, with less liquid lower-rated and higher-beta credit generally lagging across the yield curve.

Short, mid and long corporate yield spreads widened by 9, 8 and 3 bps, respectively, during the month, moving spread levels to their highest since the pandemic highs. With higher all-in yields and a dearth of long bond corporate issuance, asset-liability managers picked away at secondary market long-term corporate bonds which was supportive of long-term credit yield spreads. On an absolute return basis however, long-tern bonds materially underperformed due to the bear steepening of the underlying Government of Canada yield curve, which saw 5, 10 and 30-year yields rise by 9, 8 and 19 bps, respectively.

On an industry basis, the best performance came from pipelines as healthy credit metrics, improving counterparty risk and reduced issuance expectations buoyed credit spreads. Oil and gas continued to outperform amidst high energy prices and early call redemptions on deleveraging efforts. With increased aversion to spread volatility, utilities, infrastructure, and retail benefitted. A notable exception however was Emera, the parent company of Nova Scotia Power, which was negatively impacted by the proposed electricity cap rate legislation by the NS government which would override the regulatory framework and may result in a negative rating action.

Amidst a higher and more volatile rate backdrop, real estate issuers underperformed as concerns over high leverage and potential asset deterioration weighed on the industry. Volatility in real estate issuers also pressured the pension space through their real estate subsidiaries. Concessionary pricing on domestic bank supply marginally weighed on subordinated bank, bail-in and other financial debt, including insurance and services. Finally, concerns over consumer financial health pressured securitization (mortgage and credit-card receivables) and auto debt.

Outlook & Strategy

Risk assets are still vulnerable to higher interest rates, reduced liquidity and more importantly a recession. 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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