Focused Corporate Bond

December 2022

Market Highlights

Domestic credit markets were under pressure through October as rate volatility, monetary policy uncertainty and declining liquidity going into bank year-end bruised market sentiment. Credit yield spreads reacted by widening to their highest levels since the pandemic peak. Credit rallied thereafter as Fed communication was indicative of a more imminent pivot in policy and reversal of interest rates. The reduced upward pressure on yields, coincided with attractive corporate bond yields, better-than-expected earnings reports and improved investor sentiment. Amidst this backdrop, primary issuance was robust and lower-rated, higher-beta debt outperformed with the spread differential between BBB and A rated debt retracing earlier widening.

For the quarter, Canadian investment grade yield spreads tightened by an average of 10 basis points with the credit curve bull steepening as short, mid and long-term spreads tightened by 10, 12 and 9 bps respectively. On an absolute return basis, long-term bonds materially underperformed due to higher underlying Government of Canada yields, with all-in corporate yields for short, mid and long-term credits rising by 9, 0 and 9 bps respectively. Long-term performance would have been worse, had asset-liability managers not picked away at secondary market long-term corporate bonds due to the dearth of long corporate bond issuance and higher all-in yields.

On an industry basis, the best performance came from pipelines as healthy credit metrics, improving counterparty risk and reduced issuance expectations buoyed credit spreads. Telecoms followed closely behind, as there was buoyed demand for the industry given its use as a relatively liquid BBB-rated corporate bond proxy (a BCE issue was well received). Bank debt (bail-in and subordinated) outperformed, with HSBC Canada a top performer due to the announcement by RBC of its intention to acquire the firm. Beta compression also aided other BBB-rated sectors such as retail and media. More defensive, high-rated issues in infrastructure, power generation and utilities underperformed. Real estate also underperformed, as the volatile rate backdrop drew concerns over high leverage and potential asset deterioration which weighed on the weaker issuers. The volatility in real estate issuers also pressured the pension space through their real estate subsidiaries. Finally, concerns over consumer financial health pressured securitization (mortgage and credit-card receivables) and auto debt.

Portfolio Activity

Given relative value, the portfolio's exposures to outperforming pipeline and transportation (highway) debt were reduced and positions in higher-rated pension and real estate issues, which had underperformed, established.

The portfolio's conservative, relative shorter-term duration, steepening yield curve and high-credit quality biases were maintained.

What Worked in the Quarter

Performance benefited from industry and issuer composition, including overweights of outperforming pipeline, telecom, media and bank debt (senior debt of Big 6 and non-DSIB such as HSBC Canada), which resulted in greater yield spread narrowing than the market (15 bps versus 10 bps respectively on a duration weighted basis). The portfolio was underweight utility, infrastructure, securitization, auto, real estate and hybrid debt which underperformed.

The portfolio was short duration and positioned for a steepening of the credit curve which benefited relative performance given overall yield movements.

What Didn't Work in the Quarter

The portfolio was conservatively structured relative to the benchmark which resulted in a lower relative yield carry.

Outlook & Strategy

Risk assets are still vulnerable to higher interest rates, reduced liquidity and more importantly a recession. However, given significantly higher corporate yields over the last year, they offer attractive risk/reward opportunities, particularly in shorter maturities. We anticipate that investors will cautiously look to credit as a source of attractive yield carry, particularly amongst short-term credit given the significant inversion of the yield curve and relative flat corporate yield spread curve. Speculative grade markets may be volatile as weakened fundamentals and refinancing risk concerns continue to weigh on the market. 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. The portfolio has good liquidity and is well positioned to capitalize on relative value and yield enhancement opportunities.

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