Focused Corporate Bond

January 2023

Market Highlights

Credit rallied in January amid disinflation, bond inflows and lower sovereign yields amidst growing expectations for pivots in Federal Reserve and Bank of Canada monetary policies later this year. The Bank of Canada ratified investor optimism (both in the US and Canada) by raising policy rates by an expected 25 basis points, and more importantly, signalling a move to the sidelines for further tightening, unless inflation proves them premature. The BoC’s stance also raised further doubts on the conviction of the Federal Reserve's stated higher-for-longer preference. For the month, domestic investment grade yields fell by 44 bps, with financials and lower-rated, higher-beta debt generally outperforming.

For the month, short, mid and long-term credit spreads narrowed by 14, 12 and 10 bps respectively. The bull steepening of the credit spread curve reflected relative value in short-term corporates given the yield curve inversion and attractive breakeven protection. Absolute returns were augmented by the rally in sovereign yields as 2, 5, 10 and 30-year yields fell by 30, 38, 38 and 30 bps respectively. The rally across the domestic yield curve, maintained the 2-30 yield curve inversion at 78 bps which is near decades high.

Given positive funding dynamics, there was of $11.3B of primary issuance in January, surpassing the 5-year average of $9.4B. Deals were well oversubscribed and new issue concessions vanished with certain transactions coming flat or even through secondary curve levels. Notably, there was a three-tranche Hydro One deal totalling $1.05B of inaugural ESG labelled sustainable bonds, which was the largest labelled ESG (use of proceeds) bond issued in Canada to date. However, the funding premium over secondary Hydro One issues (the “Greenium”) was only 1-2 bps (a drop from >10 bps in recent years) as new investor interest in the ESG space has waned.

Across the credit curve, the best performing issues were predominately lower-rated, higher-yielding and higher beta. Telecom was the top performing industry as it serves as a liquid BBB-rating proxy. Beta compression aided other BBB-rated sectors such as pipelines, autos, real estate and media. Bank, securitization and insurance issues also outperformed on well received senior and subordinated issuance, a steepening yield curve and expectations of reduced supply this year. More defensive, high-rated issuers in infrastructure, utilities, power generation and public-private partnerships underperformed. Oil and gas also underperformed, as other industries provided more attractive relative value following last year’s significant outperformance.

Outlook & Strategy

Risk assets have begun the year with a substantial bid but remain vulnerable to more hawkish monetary policy, slower disinflation, and a more pronounced economic deceleration. Corporate bonds offer more attractive risk/reward opportunities, given the significantly higher yields realised over the last year. We anticipate that investors will cautiously look to credit as a source of attractive yield carry, particularly in the short-term area where the risk/reward opportunities are the most attractive, given the significant inversion of the yield curve and relative flat corporate yield spread curve. Speculative grade markets may be volatile as weakened fundamentals, refinancing risk concerns and the threat of recession periodically 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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