Focused Corporate Bond

March 2023

Market Highlights

Credit rallied through early March amid bond inflows and expectations for rate reversals from the Federal Reserve and the Bank of Canada later this year. Risk appetite quickly deteriorated thereafter on contagion risks stemming from US regional bank turmoil and the collapse of Credit Suisse which precipitated a negative AT1 bondholder resolution. The resulting rate volatility and credit yield spread widening hampered liquidity and primary issuance (down ~46% YoY). Market sentiment improved into the final days of the quarter, as investors assessed contagion risks would be contained, leading credit yield spreads to narrow from their highs a week earlier. For the quarter, domestic investment grade spreads widened by 3 basis points with higher-beta and subordinated debt generally underperforming.

The domestic investment grade corporate yield spread curve bear flattened for the quarter with short, mid and long-term spreads widening by 6, 6 and 2 bps respectively. The flattening of the credit curve reflected investor unease over near-term event risk and credit conditions as well as the concentration of financials and higher beta industries such as real estate in the short-term area of the credit curve. Long-end credit spreads were supported by a dearth of long bond corporate issuance causing asset-liability managers to pick away at secondary market long-term corporate bonds offerings. Absolute returns were bolstered by the bull steepening of underlying Government yields, with all-in corporate yields for short, mid and long-term credit declining by declining by 29, 30 and 25 basis points respectively.

Given market dynamics, the best performing corporate issues across the curve were predominately lower beta, higher-rated non-financial issues. With their defensive characteristics, utility, infrastructure and public-private partnerships outperformed. Telecom and media debt benefitted from reduced issuance expectations, the resolution of Rogers takeover of Shaw, and the industry's essential/utility-like services. Similarly, pipelines outperformed on their utility-like business profiles and improving credit metrics. Finally, despite headlines and volatility in the bank sector, widening of credit yield spreads of domestic systemically important bank senior bank debt (legacy and bail-in) did not completely offset the narrowing seen through early March. Spread widening was however prevalent for bank subordinated non-viability contingent capital debt and senior non-DSIB issuers. Amongst bank capital securities, underperformance was most pronounced for bank AT1 NVCC limited recourse capital notes (which are not included in bond indices) in response to the Credit Suisse AT1 write-offs. Bank spread volatility weighed on other financial industry debt, including insurance and mortgage credit; given the potential dampening of macroeconomic and financing conditions, real estate and oil producers were also pressured.

Portfolio Activity

Given changes to relative value, the exposure to outperforming pipeline credit was reduced and a position in higher-rated diversified industrial debt, which had underperformed relative to pipeline credit, was established.

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

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What Worked in the Quarter

Performance benefited from industry and issuer composition, including being overweight outperforming telecom, media, industrial services, pensions, pipelines, and senior bank debt. The portfolio was underweighted or had no exposure to oil and gas, subordinated bank, and power generation debt which underperformed.

What Didn't Work in the Quarter

The portfolio was short duration (~1 year) relative to the benchmark with an underweight in the ten-year area of the yield curve. The credit curve bull flattened over the quarter with the ten-year area outperforming other terms. The more conservatively structured portfolio relative to the benchmark also resulted in a lower relative yield.

Outlook & Strategy

Recent strains in the banking sector have exposed vulnerabilities that have built over the years due to easy credit conditions. While we think concerns over bank failures will subside, we do feel that risk assets remain vulnerable to tighter 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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