Focused Corporate Bond

September 2023

Market Highlights

Early in the quarter, credit yield spreads ground towards the best levels seen since March on supportive macroeconomic data, generally positive earnings reports and a lack of primary issuance. Sentiment and risk appetite whipsawed thereafter as the "higher for longer" rate narrative settled in with issuance increasing as reluctant corporate treasurers came to accept the new rate environment, particularly high yield issuers. The rate narrative also resulted in long-end selling and a significant bear steepening of sovereign yield curves (rise in yields increasing with term) over the quarter.

Overall, domestic investment grade credit yield spreads narrowed by 3 basis points as strong credit metrics overshadowed higher debt servicing concerns. Short and mid-term corporates saw demand from cash buyers deploying funds at attractive yields amidst reduced bank issuance (from last year's record levels). Long-term demand was primarily related to liability management-driven buying of secondary issues as long-term issuance was lower than forecast. Overall corporate yields shifted higher as the underlying Government of Canada yield curve bear steepened with 2, 5, 10 and 30-year sovereign yields rising by 29, 56, 76 and 72 bps, respectively.

Across the credit curve, the performance range for industries was led by insurance, domestic non-systemically important banks, financial services, and power generation, given the attractive relative value. Higher energy prices benefitted oil and gas and integrated energy issuers. Despite growing signs of increased consumer weakness, lower-rated retail and auto debt outperformed on their yield pickup relative to less cyclical industries. Alternatively, new issuance and expected supply in pipelines, utilities, real estate, and telecom bank debt, resulted in marginally less credit yield spread narrowing.

Portfolio Activity

Given changes to relative value, the exposure to outperforming information services along with excess cash were reduced and replaced with exposure to higher-rated diversified industrial debt.

The portfolio's short duration, yield curve steepening, and high-credit quality biases were maintained.

What Worked in the Quarter

The portfolio was conservatively structured with an average duration of 4.5 years, one year shorter than the benchmark, which was positive for relative performance given the significant rise in yields.

The portfolio was positioned for and benefitted from yield curve steepening, given an overweight in short-term (<5-year) debt in lieu of long-term (>10-years) debt.

Performance also benefited from industry and issuer composition, including overweights in outperforming short-term insurance, information services, diversified industrial and senior bank debt. The portfolio was underweight utilities and securitizsation debt which underperformed.

What Didn't Work in the Quarter

The portfolio had higher credit quality versus the benchmark which resulted in a lower relative yield carry.

Outlook & Strategy

While corporate credit has remained steadfast in the face of higher rates and volatility, we do feel that a prolonged period of higher interest rates and concerns over consumer spending will weigh on risk appetite, particularly for speculative grade issuers. The risk of course, is that central banks will tighten more – they have been behind the curve this whole tightening cycle – and economies will ultimately get pushed into recession. We think the Fed has room to manoeuvre before forcing a recession, the Canadian economy is already dangerously close, affording the Bank of Canada less wiggle room.

Amid this backdrop, investors will continue to 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 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 is defensively positioned with good liquidity to capitalize on relative value and yield enhancement opportunities.

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