Focused Corporate Bond

June 2023

Market Highlights

Domestic corporate credit yield spreads narrowed into quarter-end as higher all-in yields and better-than-expected macroeconomic data and corporate earnings growth overshadowed US debt ceiling, excessive monetary tightening and regional bank concerns which caused spread widening in the middle of the quarter. During the quarter, domestic corporate yield spreads tightened by an average of 15 bps with lower-rated, higher-beta debt generally outperforming across the yield curve.

The domestic investment grade corporate yield spread curve bull flattened (yield decline increasing with term) for the quarter with short, mid and long-term spreads narrowing by 15, 13 and 17 bps respectively. Demand for short-term corporate bonds came from cash buyers deploying funds at attractive yields whereas demand for long term corporates was driven primarily by liability driven investment and index rebalancing needs amidst a dearth of long-term bond issuance. Issuers, given improved sentiment and yield curve inversion, used the opportunity to term out or use bond proceeds to repay short term debt by issuing mid-term debt. Absolute returns were dampened by the bear flattening of underlying Government yields, with all-in corporate yields for short and mid and long-term credit shifting by 55, 35 and -3 basis points respectively. The corporate credit curve is at its most inverted on record.

Across the credit curve, industry performance was led by higher-beta, lower-rated real estate issuers (all categories), mortgage providers and financial services which have underperformed year-to-date. Similarly, despite growing signs of consumer weakness, lower-rated retail and auto debt outperformed on their yield pickup relative to less cyclical industries. Bank debt (across the capital structure) and insurance rallied on manageable supply expectations, strong capital levels and minimal concerns of contagion from US regional banks. Finally, stable energy prices resulted in oil producer and pipeline credit outperformance. Alternatively, given reduced risk aversion, defensive utility and infrastructure issuers underperformed; while the addition of reduced liquidity amongst longer-dated illiquid public-private infrastructure projects generated some of the worst corporate performance.

Portfolio Activity

Given the significant inversion of the yield curve, our forecast for the yield curve to steepen (higher yields of long bonds relative to short bonds) and attractive relative value, coupon payments were reinvested into short-term senior bank debt.

The short duration, steepening yield curve and high credit quality biases of the portfolio were maintained.

What Worked in the Quarter

The overweight's in outperforming issues of senior bank debt, insurance, pipeline and telecom and underweights in underperforming utilities, infrastructure and public-private-partnership were positive contributors to performance. Additionally, the portfolio was short duration which benefited relative performance given the rise in yields.

What Didn't Work in the Quarter

The portfolio was conservatively structured with concentrations of short and mid-term debt in lieu of long-term debt which was negative for performance given the significant bear flattening of corporate yield curves.

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

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Outlook & Strategy

Throughout the tightening cycle, investors and policy makers have underestimated monetary tightening, highlighting the challenges of forward guidance and its effect on market volatility. We expect volatility will continue until policymakers are more convincingly on hold. While corporate credit has remained steadfast in the face of recent volatility, 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. 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 has good liquidity and is well positioned to capitalize on relative value and yield enhancement opportunities.

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