LORICA

Focused Corporate Bond

December 2023

Market Highlights

Early in the quarter credit was pressured as rate volatility and geopolitical events soured investor risk sentiment. Thereafter credit rallied to the best levels in two years as markets priced in central bank pivots to aggressive rate cuts on expectations of moderating inflation and an economic soft landing. Domestic investment credit yield spreads tightened by 17 basis points over the quarter with lower rated, higher beta names outperforming.

For the quarter, short, mid, and long-term domestic credit yield spreads narrowed by 20, 22 and 7 bps, respectively. The bull steepening of the credit yield spread curve (greater short term credit yield narrowing relative to longs) reflected increased profit taking and de-risking in long-term credit to roll down the credit curve given the rate rally and inversion of the government yield curve. Lower corporate issuance (down 15% YoY due to reduced domestic bank issuance) also continued to act as a tailwind for credit yield spread narrowing. Absolute returns were primarily driven by the bull steepening of the Government of Canada yield curve which resulted in short, mid and long-term corporate yield declines of 118, 120 and 94 bps, respectively.

Across the credit curve, industry performance was led by telecom issuers, given the lower-than-expected spectrum auction spending, accelerated deleveraging, and the proxy-like behaviour for liquid corporate BBB-rated credit, while having less volatility given the utility-like business profile. Insurance performance closely followed as speculation rose that OSFI may implement a resolution regime (as was done for the domestic banks) that would result in the addition of non-viability contingent capital securities and the phasing out of existing debt. With increased risk appetite, subordinated and higher yielding issues in pipelines, bank, and autos also outperformed. Alternatively, higher-rated defensive infrastructure and utilities issuers underperformed. Lower energy prices pressured the credit yield spreads on integrated oil and gas issues. Finally, ongoing concerns over office real estate weighed on office REIT issuers.

Portfolio Activity

Exposures to short and mid-term telecom and senior bank debt, which offered attractive relative value, were increased using proceeds from coupon payments and the sale of information services debt, which had outperformed.

The portfolio's short relative duration was reduced from 1 1/3 years to 1 year, reducing the steepening bias. The industry and high credit quality biases were maintained.

What Worked in the Quarter

Performance benefited from industry and issuer composition, which included overweights in outperforming insurance, telecom, pipeline, industrial, and bank (senior debt of Big 6 and non-DSIB such as HSBC Canada) issues, which resulted in greater yield spread narrowing than the market – 20 bps versus 17 bps on a duration weighted basis. The portfolio was underweight utility, infrastructure and oil and gas credit which underperformed.

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.

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What Didn't Work in the Quarter

The portfolio was conservatively structured with an average duration of 1 1/3 years shorter than the benchmark, which was negative for relative performance given the significant decline in yields.

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

Outlook & Strategy

We don't believe the Q4 rally signals the end of market volatility. Rather, we believe that government yield curves and credit markets, as currently priced, are incompatible and both will likely need to re-adjust. The amount of easing priced into the US and Canadian yield curves implies deflation or recession or both by early next year, while credit markets are priced for much lower policy rates and a soft landing.

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 the threat of a 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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