JANUARY 2023

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High Quality Corporate Bonds - An Opportunity for 2023

This year has been turbulent for all asset classes, and particularly so for bonds as they have failed to provide the expected downside protection against falling equity markets. Inflation has skyrocketed, forcing central banks to pivot from extremely loose to extremely tight monetary policy within the same year.

This year has also revealed how heightened uncertainty leads to elevated volatility and widens the range of potential outcomes. As most of the traditional approaches to fixed-income investment disappointed in 2022 due to fast-rising rates, investors have started evaluating how they can optimize their fixed-income portfolios more effectively. High-quality corporate bonds can help to cushion a bond portfolio against the negative implications of rising rates and we believe interesting opportunities have emerged for astute investors.

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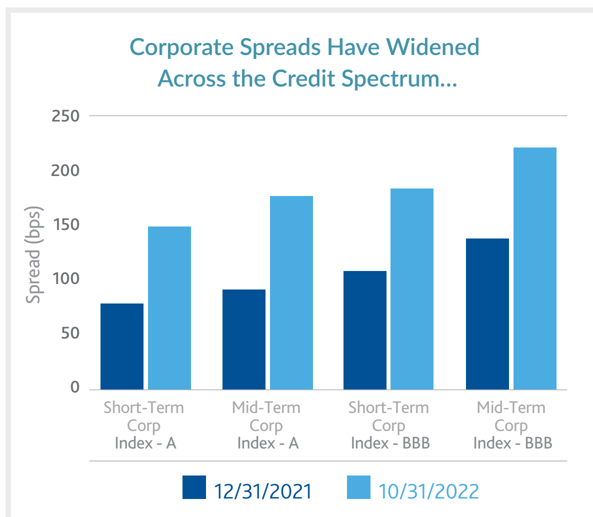
Investing in Uncertain Times

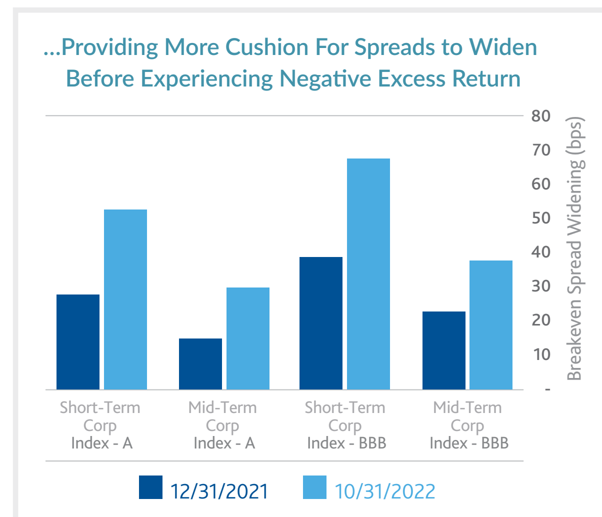
High-quality corporate bonds are a prudent way to add excess yield over and above the risk-free government yield, which is best achieved by allocating a percentage of the portfolio to corporate bonds. Over the past two decades, corporate bonds have become a larger and more diversified sector within Canadian bond indices. As government bond yields were forced lower through accommodative monetary policy during much of the last decade, investors' need for higher yields made corporate bonds increasingly more attractive. Over this period, investors have become more comfortable with higher allocations to investment-grade corporate bonds within their portfolio.

Corporate bond spreads have historically been highly correlated to the economic cycle. As fears of an economic recession have mounted, investment-grade corporate bond spreads have widened significantly and are now approaching the widest levels in almost a decade, outside of the COVID pandemic. These wide levels are driven by various macro factors such as hawkish central banks, slowing growth, as well as ancillary issues from the Russia/ Ukraine conflict. However, wider spreads result in higher yields, which provide a good portfolio defense against any further rate increases and improves the future return prospects for bond portfolios. For example, the breakeven spread widening represents how much credit spreads would need to widen before the excess return of corporate bonds versus government bonds turns negative. As credit spreads have increased across both the quality and maturity spectrum, the breakeven point has moved higher resulting in greater portfolio insulation to spread movements.

We believe the current spread-widening episode is unique and presents interesting opportunities for investors willing to look past the headlines and dig deeper into the fundamentals. While most previous economic downturns and credit spread widening events revolved around excess risk-taking and poor credit underwriting, causing general growth uncertainty and financial market instability, the current economic backdrop stems from loose monetary policy and fiscal stimulus over the last two years. For the most part, corporate and consumer balance sheets are substantially stronger this time around.

Investment-grade corporate credit spreads are tracking near cyclical wide levels. However, fundamentally, most investment-grade companies continue to generate large amounts of excess cash and reduce leverage, having demonstrated conservative business management during the COVID pandemic. Arguably, credit spreads for such issuers have now approached levels that are considered quite wide for their fundamentals. As an example, Canadian energy companies have been able to improve their debt dynamics significantly post-pandemic and have on average lowered their leverage ratios.





Source: Fiera Capital and FTSE Global Debt Market Indices

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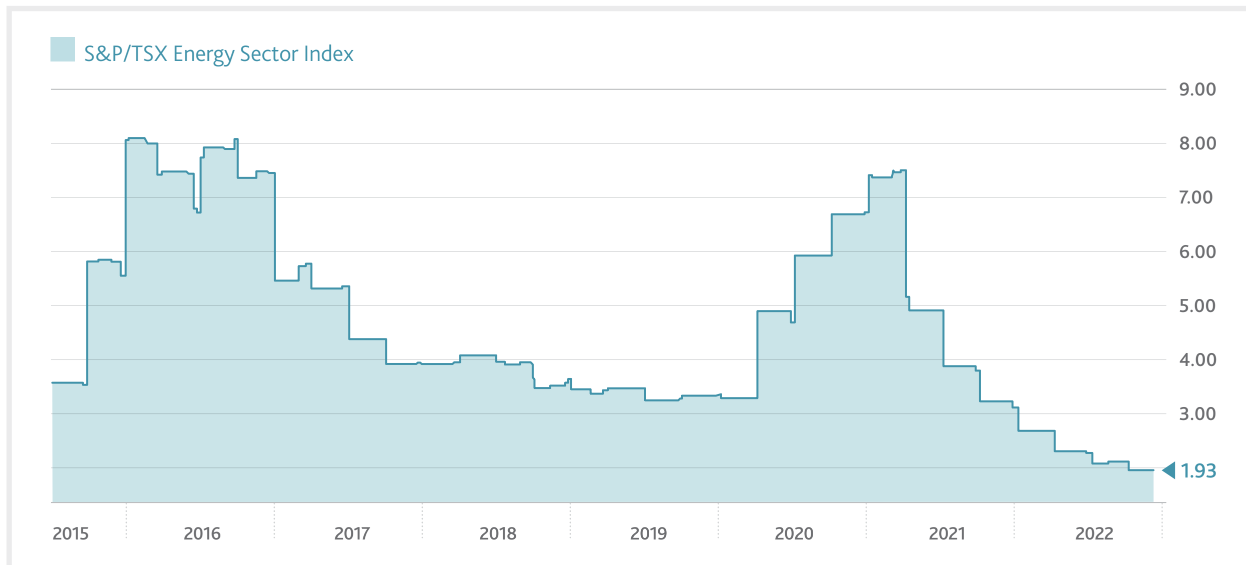
Total Debt to EBITDA for the Canadian Energy Sector:



Source: S&P/TSX Composite, Bloomberg Financial LP

Despite these strong micro fundamentals, as we move closer to a possible recession over the next 6-12 months, credit spreads are expected to remain somewhat volatile in the near term due to the underlying macro factors driving the global economy. We expect credit spreads to be range-bound over the next few months and peak sometime in Q1 2023, as we approach the end of the current rate hiking cycle. This is expected to come ahead of the final rate hike by the Bank of Canada as well as the Federal Reserve.

Wide credit spreads and higher yields among corporate bonds are the result of investors requiring more compensation during a period of heightened uncertainty. This has resulted in bouts of volatility and lower liquidity in the corporate credit markets which is expected to ebb somewhat as we move closer to the end of the current rate hiking cycle. The surge in bond yields and wider credit spreads have also led to opportunities in the fixed-income market not experienced in many years. As corporate treasurers reconcile with higher yields, issuers continue to opportunistically access the primary market for funding while investors use some of their higher cash balances to opportunistically invest in cheaper high-quality debt.

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The Opportunity

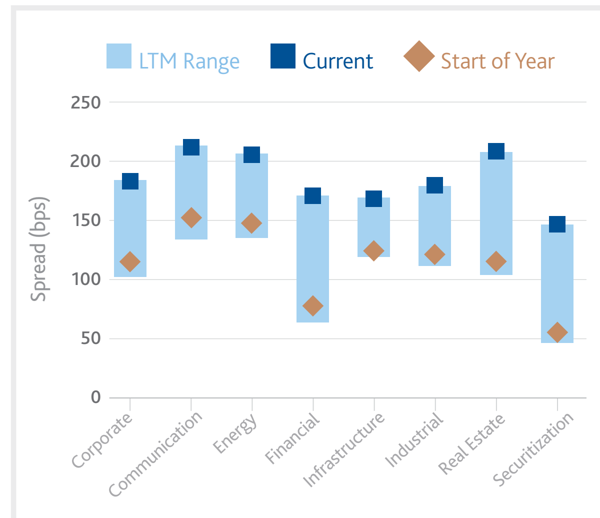
Within the Canadian investment-grade corporate space, the current spread widening has presented many interesting opportunities. Companies with strong business risk profiles and firms with higher credit ratings are trading at levels rarely seen since the 2007-08 global financial crisis. For example, the 5-year senior unsecured debt issued by the largest Canadian banks widened significantly this year and now trades 2.2x wider than last year while these banks continue to be highly capitalized with very little credit deterioration in their loan books. Similarly, high-quality utility issuers such as Hydro One Inc. is trading roughly 1.7x wider in the 5-year term, offering a good opportunity over last year's valuation. The issuers in the telecommunication sector with strong and predictable free cashflow, continue to offer utility-like returns, but at BBB-rated spread levels.

In addition, some technical factors have also contributed to good relative value opportunities this year. For example, larger than normal supply in the primary market by the financial issuers resulted in financial sector spreads widening by a larger margin than non-financial sectors. This has made some of these debt securities appear much more valuable, on a relative value basis, than they were just a year ago.

Credit curves have also flattened this year providing better relative value opportunities in the mid-term section of the curve. In the near-term, mid-term bonds should continue to provide better value given the inversion of the sovereign yield curve. Long-end credit is anchored by strong demand from duration investors and this dynamic is not expected to reverse in the near-term providing fewer opportunities further out the curve. On the credit rating side, high-quality "A" rated issuers continue to be in high demand given their strong business and financial risk profile. In the "BBB" rating bucket, issuers with utility-like stable free cashflows in the communication sector as well as long-term contractual cashflows in the energy space also offer good opportunities.

Corporate Mid-Term Spreads (vs Canada Non-Agency)

LTM Spreads



Source: Fiera Capital & FTSE Global Debt Market Indices, October 31, 2022
LTM: Last Twelve Months

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In Summary

The current interest rate cycle is getting closer to its end. The Bank of Canada and Federal Reserve are both expected to keep rates elevated until a clear signal show that inflation is receding from its lofty level. This might not happen until late 2023, due to the lagging nature of inflation. As we move closer to a potential recession, investors are paid to put slightly higher corporate credit risk in their fixed-income portfolios as in our opinion, the worst of the rate increases and spread widening is behind us. We believe fixed-income investors can focus on investing in securities issued by companies that operate with low business risk and produce stable, predictable cashflows. Companies with well-capitalized balance sheets, low leverage and strong credit metrics present an opportunity to invest with a degree of certainty during uncertain times.

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