INSTITUTIONAL

GIVING CREDIT WHERE CREDIT IS DUE

March 2016

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Executive summary

Since 2008, most active bond managers have been overweight corporate bonds – this tactical positioning has paid off. Corporate bonds have not only provided attractive yield levels above federal bonds; they have also benefited from a narrowing yield differential (the spread) as markets normalized post-financial crisis. This dual benefit (initial excess spread and subsequent spread narrowing) warrants an evaluation of corporate bonds as a tactical investment opportunity after periods of significant credit spread widening. In light of the spread widening we have seen over the last 18 months, this paper dissects the causes and highlights the opportunities actionable by investment committees in today's environment.

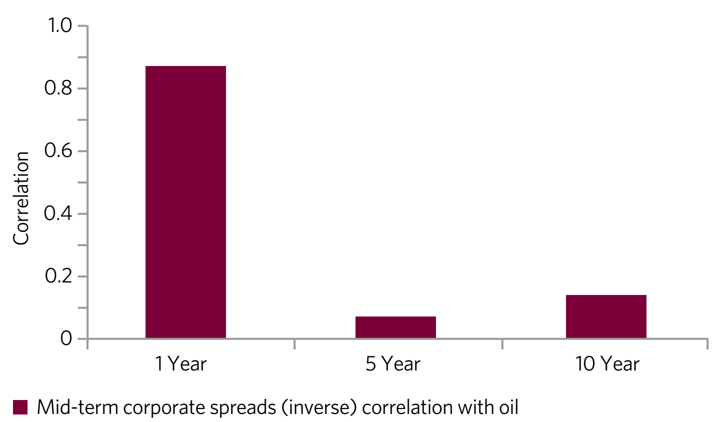
Teetering on the edge or opportunity awaits?

Many of our clients have asked us whether the current market environment is another Great Financial Crisis in the making. Others have asked if today's spread levels provide one of the most attractive value propositions in credit since the crisis. The polarity in sentiment highlights the extremes of fear and optimism we are currently witnessing. Granted, there are many variables which are legitimate, including a severe sell-off in the energy complex and fears of a slowing Chinese economy, along with its effect on a possible global recession. However, we believe we are not falling into another financial crisis or severe global recession. Investors and their managers need to separate the "risk-off" tone from the fundamentals underlying credit markets. If we are able to delineate between the two, we can then see that spreads have reached levels that are attractive and merit consideration.

What are the factors driving spreads today?

Headlines have been dominated by high-yield spreads that continue to widen to levels not seen since 2010/11 when the European financial crisis loomed over markets. Unlike the prior period, when European sovereign risk drove markets into "risk-off" mode, today's version of spread widening in high yield has been led by energy and materials names. These names decoupled from the broad high-yield index in late 2014 on the back of weakening prices in the commodity complex. During this time, we watched the market's obsession with oil increase, while Canadian credit spreads (Figure 1), as well as most asset classes, became highly correlated with the price of crude.

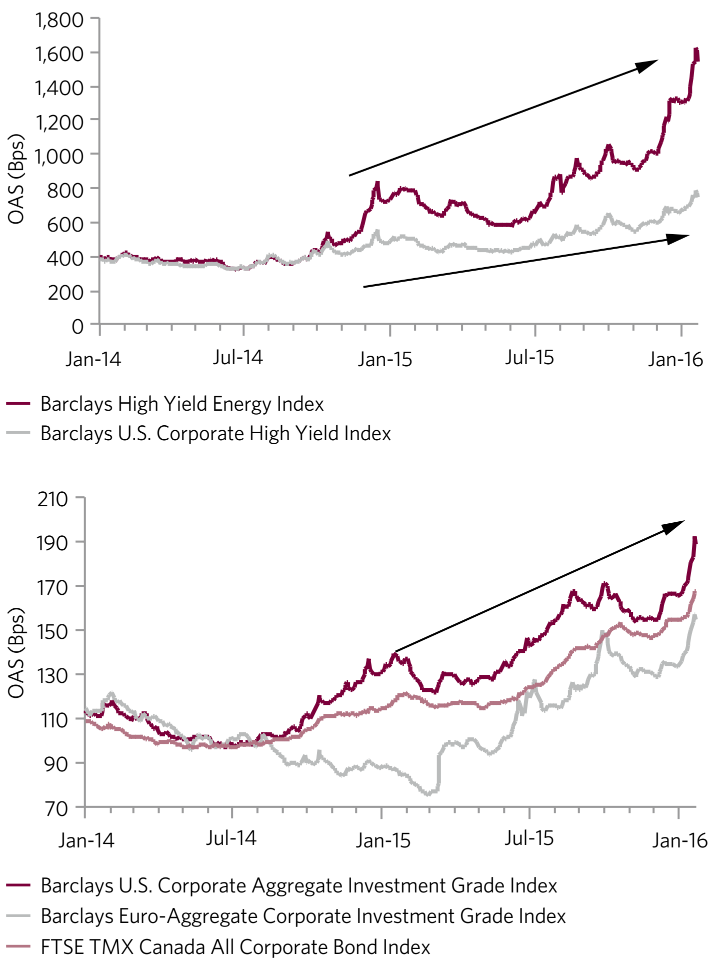
Figure 1 – Correlation between spreads and oil



As of December 31, 2013. Source: AON Hewitt

The initial deterioration in high-yield energy and materials spreads began to drag the broad high-yield index down and eventually led to a broad-based sell-off in high-yield markets, regardless of the connection to energy prices (Figure 2, left chart). Just as energy names placed pressure on the whole high-yield market, so too has high yield pressured high-grade indices, also dragging these markets to wider spread levels. Such moves have been further exacerbated by a slowing Chinese economy and fears of a global recession. The initial impact of these concerns on U.S. high-grade credit had the usual knock-on effect on Canadian credit, with our spreads now also hitting the highest levels in nearly five years (Figure 2, right chart). Spreads also reacted to the additional pressure of a slowing Canadian economy, especially on the back of energy weakness.

Figure 2 – Trends in credit spreads from energy to investment grade

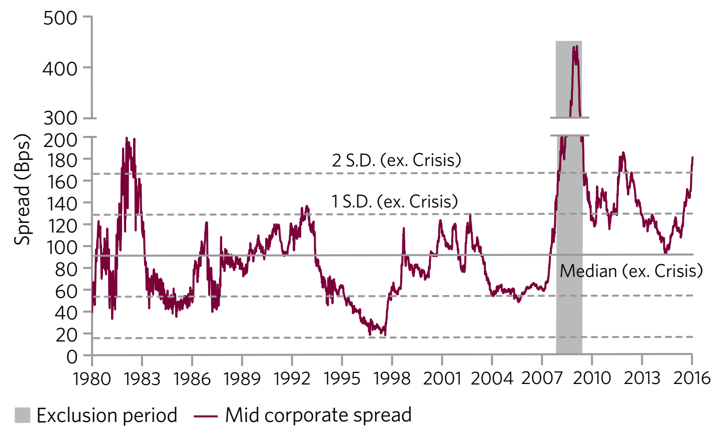


Sources: Barclays, FTSE TMX Debt Capital Markets and CIBC Asset Management

Understanding where we are within the historical context

With all this upward pressure on credit spreads, we believe it is important to understand the magnitude of this move within the historical context, especially when considering a strategic position/increase in corporate bond exposure. Based on the January 1980 through February 2016 time period, Canadian investment-grade mid-spreads (a duration neutral proxy) have surpassed a one standard deviation move, a level not observed since late 2011 or mid-1992. Removing the extreme wides reached in the financial crisis from the equation (a tail event which skews the numbers higher), reveals that today's mid-corporate spreads sit above an astonishing two standard deviations for the same period (See Figure 3).

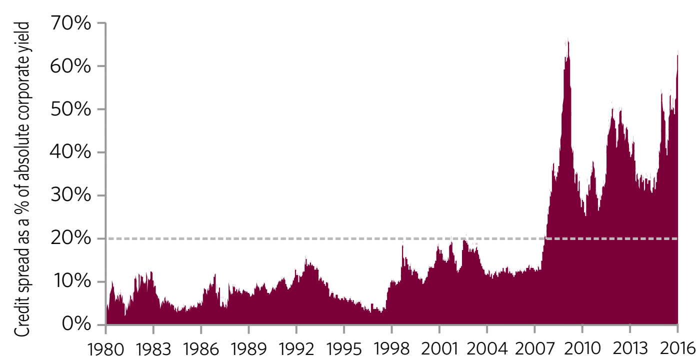
Figure 3 - Standard deviation of spread movements



Exclusion period defined by Canadian recession. Source: FTSE TMX Debt Capital Markets and CIBC Asset Management

When observing credit spreads as a percentage of the all-in corporate yield, we also see levels far above the long-run historical average (Figure 4).

Figure 4 – Credit spreads moving absolute yield

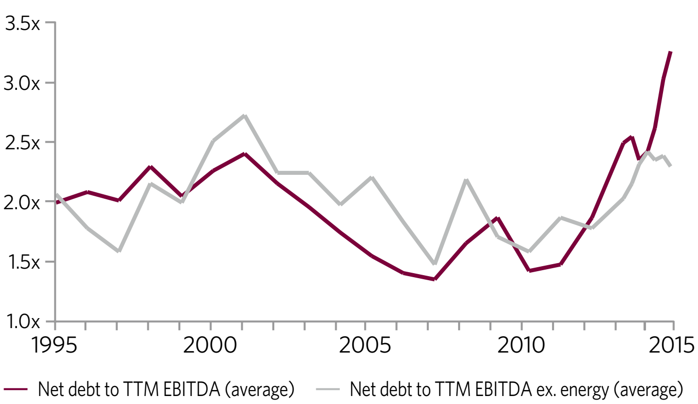


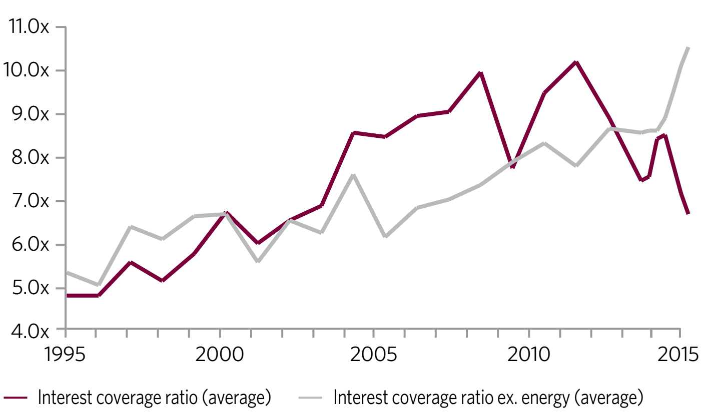
Based on mid-corporate spreads. Source: FTSE TMX Debt Capital Markets and CIBC Asset Management

Be selective – approach the opportunity from a risk management perspective

With the previously mentioned market movements now making investment-grade credit an attractive value proposition, we believe it is important to be selective in corporate weightings with an eye towards managing downside risk. At these levels, initiating or increasing allocations to corporate credit is opportunistic. We must recognize that certain issuers and sectors have experienced real deterioration in fundamentals, while others have simply widened on the back of the general sell-off and now provide attractive yield levels not observed for many years. From a fundamental point of view, we consider it necessary to separate the driver of "risk-off" trading from opportunities still found in other industries and markets which continue to benefit from record low funding costs. Although broad market leverage ratios appear to be increasing while interest coverage ratios are declining, we find that excluding energy names paints a very different picture – one that is much more constructive for corporate fundamentals (Figure 5A & 5B). Although revenues are exhibiting a downward trend, the drag from the energy sector has clearly decoupled from the remaining Canadian industries, which are still positive. By highlighting the dichotomy between energy and non-energy sectors, we can see that recent spread shocks are, in some part, being driven more by macroeconomic fears rather than the credit quality of individual issuers.

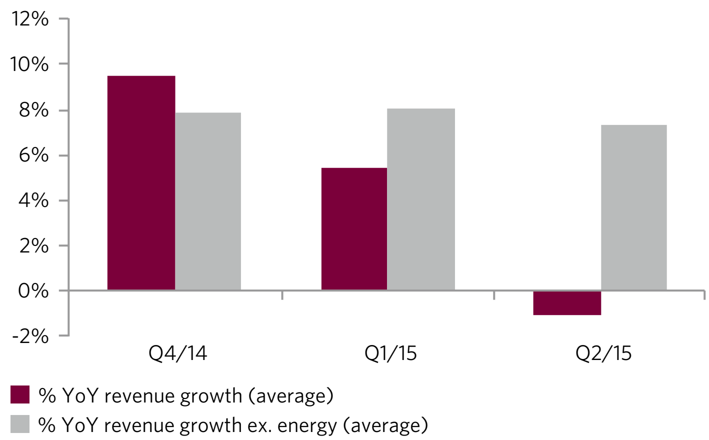
Figure 5a – Investment grade coverage ratios (ex. financials)





Represented by S&P/TSX constituents, excluding financials. Source: RBC Capital Markets

Figure 5b – Investment grade revenue growth (ex. financials)



Represented by S&P/TSX constituents, excluding financials. Source: RBC Capital Markets

The above divergences point to the importance of proprietary credit research that is able to delineate between broad-based influences on credit spreads versus the fundamental drivers of credit quality and valuation. We have always been fervent in our view that independent credit research is an essential quality control mechanism within corporate allocations. Independent research can provide early warnings of credit deterioration long before rating agency downgrades.

Connecting past periods of spread widening and performance

Does the past teach us about how bond markets perform in extreme environments such as today? We believe the answer is a resounding "yes". Table 1 shows the annual change in credit spreads and the impact on performance for different fixed income sectors including corporates. Even in extreme spread-widening periods, corporate bond performance is better than expected. And despite the violent credit sell-off in 2008, corporates still managed to post a small positive return. This consistent positive performance is mainly attributed to the fact that investment-grade corporate bonds have a built-in hedge against poor economic growth trends, which is typically the cause of credit spread widening. When the market prices a future slowdown in economic growth, interest rates begin to fall, which has a positive impact on corporate bond prices. This offset helps to cushion the impact of spread increases.

Table 1

Return by sector	2015	2014	2013	2012	2011	2010	2009	2008	2007	2006
Mid-Spread move (Bps)	+32	+2	-19	-49	+51	-3	-302	+292	+84	+6
Federals	3.66	6.91	-1.52	2.11	8.41	5.39	-0.21	11.51	4.62	3.62
Provincials	4.14	12.18	-2.7	3.37	13.17	8.56	6.19	5.31	4.23	4.36
Corporates	2.71	7.58	0.84	6.22	8.24	7.34	16.26	0.23	1.79	4.39

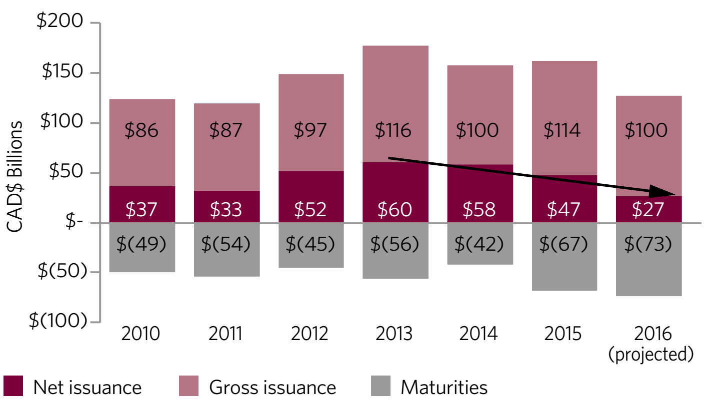
Sources: FTSE TMX Debt Capital Markets and CIBC Capital Markets

Conditions supportive of credit

Certain market conditions have formed to bolster our belief in selective overweights of corporate bonds. The following lists a few metrics that support our case:

1) Supply vs. demand
2016 net issuance is projected to be the lowest in years while demand for corporate bonds in today's low yield environment is expected to persist. The combination of lower supply and continued demand should be supportive of spreads.

Figure 6 – Net issuance in Canadian markets



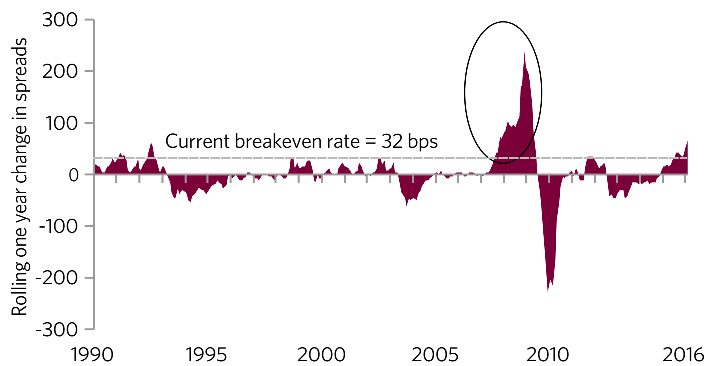
Sources: CIBC Asset Management and BMO Capital Markets

We believe that the demand for corporate bonds could increase as today's higher yield levels attract new investors. During 2016, expected reduced supply will likely create an imbalance that will cause corporate bond prices to correct in favour of existing investors.

2) Breakeven rates
Existing breakeven rates illustrate the amount of cushion embedded in a corporate bond allocation, thanks to the current spread environment. Although we look at breakevens across the curve and for a variety of corporate bonds, a simple index illustration shows that spreads have now widened to the point where breakevens are at relative highs. From today's vantage point (with a one-year horizon), the FTSE TMX Canada All Corporate Bond Index would have to endure a further 32 basis points (bps) spread widening before capital losses eliminate the additional yield. This is above the 23 bps breakeven rate seen in 2014, and far beyond historical levels, which have generally been around half that value.

Looking at historical rolling one-year moves in credit, the only times in which spreads have made a move large enough to eliminate today's current cushion was during the financial crisis period (Figure 7).

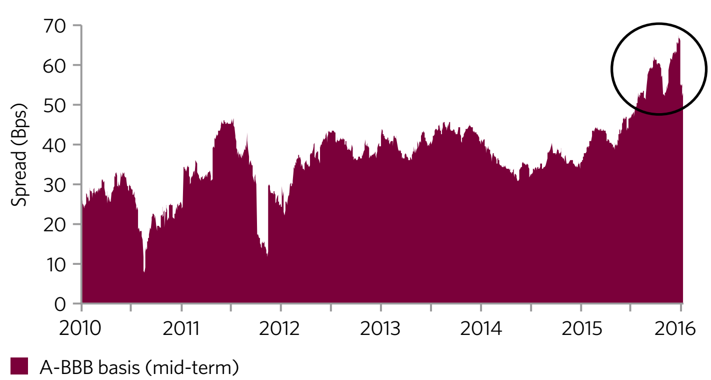
Figure 7 – Historical one-year spread widening (all corporates) vs. current breakeven rate



Sources: FTSE TMX Debt Capital Markets and CIBC Asset Management

3) Relative value
Although spreads widened considerably across the board, we are now beginning to see opportunities for relative value positioning emerge as the market exhibits greater differentiation across sectors and ratings categories. These opportunities have not existed for several years. Examining the A-BBB basis (the spread difference between the two rating categories) shows strong opportunities to position both on the higher and lower end of the rating spectrum to capture valuation inconsistencies in the market.

Figure 8 – A-BBB basis

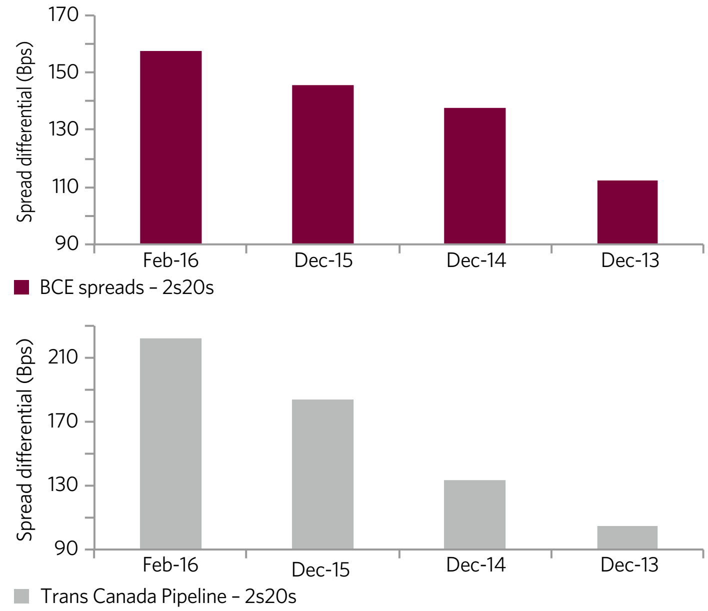


Sources: FTSE TMX Debt Capital Markets and CIBC Asset Management

4) Changes in the credit curve

Canadian corporate bond managers typically favour shortterm corporate bonds, given that the corporate curve is generally flat (in other words, the spread between a 2-year corporate bond and the same 10-year corporate bond is similar), and because a corporation's future cash flows are less predictable the longer the outlook. Therefore, there is a belief that an investor is not well compensated for going out the credit curve to take on more credit risk. However, when spreads exhibit high volatility as we are experiencing today, we can see a steepening of the credit curve. This gives an investment team with strong credit research capability the confidence to venture further out the curve and exploit the steeper term structure. Steeper curves also offer greater rolldown opportunities, which can be captured as time passes and the credit curve flattens back to its normal position. Figure 9 shows two select Canadian corporate issuers with spread curves that are now exhibiting the steepest levels seen since the financial crisis.

Figure 9 – Select curve steepenings

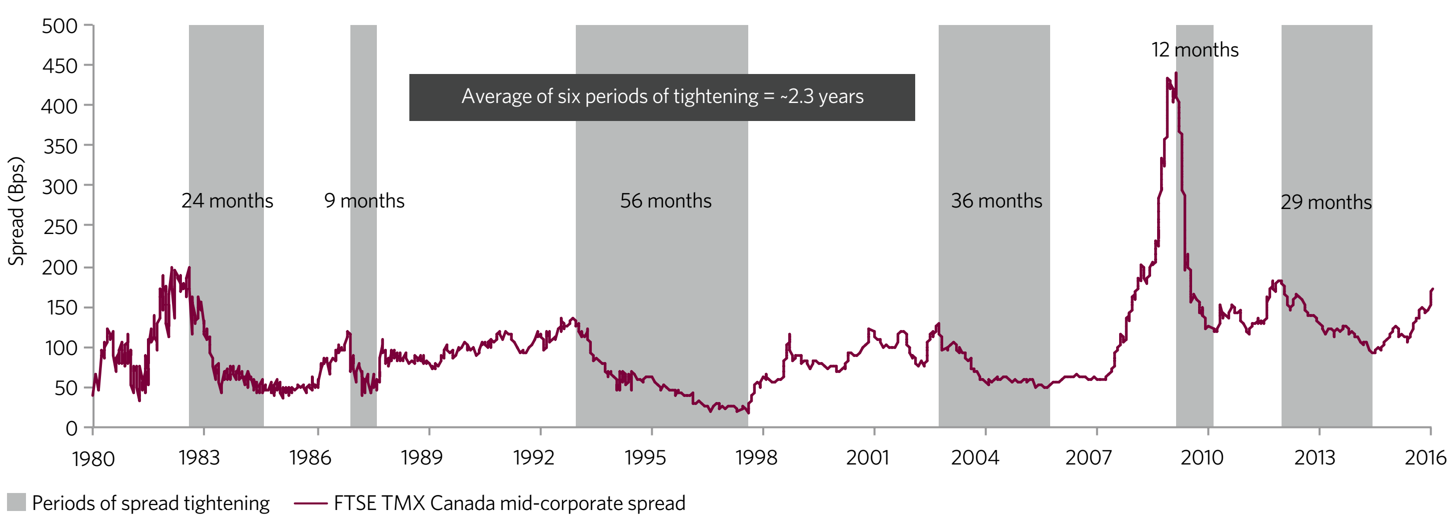


Sources: FTSE TMX Debt Capital Markets and CIBC Asset Management

Remember the length of the credit cycle

While we recommend a selective overweight in corporate bonds, investment committees and their managers must keep in mind that spreads could take some time before tightening back to levels that are closer to historical averages (Figure 10). Generally speaking, when considering peak-to-trough moves in credit spreads, we see a 2-year cycle, on average. Our view is based on examining historical averages, recognizing that there were periods in which spreads have tightened considerably faster (approximately 9 months in 1986), or have taken considerably longer (approximately 56 months in 1993). This is particularly important for investors who may have shorter time horizons, although we would argue that, at current yield levels, investors are generally being paid to wait for spreads to retrace recent wides, thanks to current excess spread.

Figure 10 – Periods from wides to spread tights



Sources: FTSE TMX Debt Capital Markets and CIBC Asset Management

How to take advantage of this opportunity?

Actionable options exist for investment committees to take advantage of this opportunity:

For those who are biased to rely on passive management for fixed income, today is a good time to reconsider that belief, even on a tactical basis.

For those who are already implementing an active fixed income approach, opting for a dedicated corporate bond strategy might be a valid consideration.

For those who already invest with a dedicated corporate bond manager, now is a good time to re-evaluate that manager. Investment committees should ask the questions:

- How does my manager invest in corporate bonds?
- Does the manager simply attempt to capture some illiquidity premium?
- Does the manager fully analyze the entire corporate universe with an eye to risk management?

We argue the latter is the prudent approach to take.

Conclusion

Recent headlines and market movements certainly suggest we are in extraordinary times. In our view, it is during extraordinary times that active managers have the opportunity to successfully put their clients' assets to work by separating the true signal from the noise. We believe indiscriminate macroeconomic fears mean that today's corporate yields are beginning to reach levels that compensate investors for short-to-medium risk factors, macro and fundamental. Prices are low, the relative value opportunity is appealing and the expected duration of the spread recovery is relatively short. Finally, if using the proper credit selection team, the risk metrics are in an investor's favour.

For more information, visit: www.cibcam-institutional

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