TD Asset Management

Market Perspectives + 20 Minutes = Current Insights

Identifying Pockets of Value in Corporate Bond Markets

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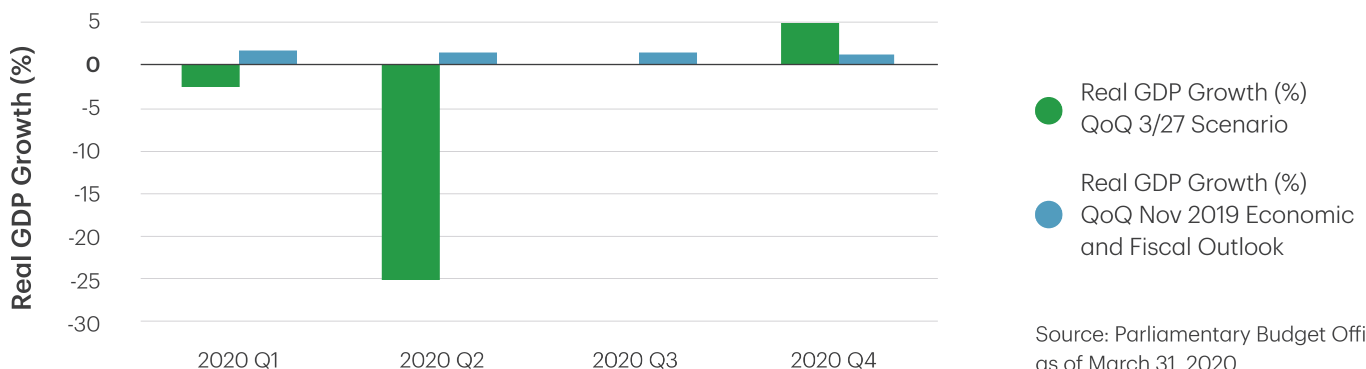
What happened?

March of 2020 brought extreme levels of volatility to financial markets, with fixed income markets not being immune to the rapid repricing exhibited. In this article, we look to address why corporate bond spreads widened, why TDAM ("we") sees relative value opportunities in the corporate sector, and how we are capitalizing on the current market dislocation.

The intentional shutdown of economies worldwide, in response to the growing COVID-19 pandemic, is expected to have broad near-term economic impacts. The odds for a global recession have increased meaningfully as per the chart below, as investors attempt to gauge the impact it will have on economies and corporations. This increased probability of a recession is being met with a clear intent from global policy makers to provide significant economic stimulus, using the combination of both fiscal and monetary measures.

Initial projections show significant growth headwinds in Canada



Source: Parliamentary Budget Officer, as of March 31, 2020.

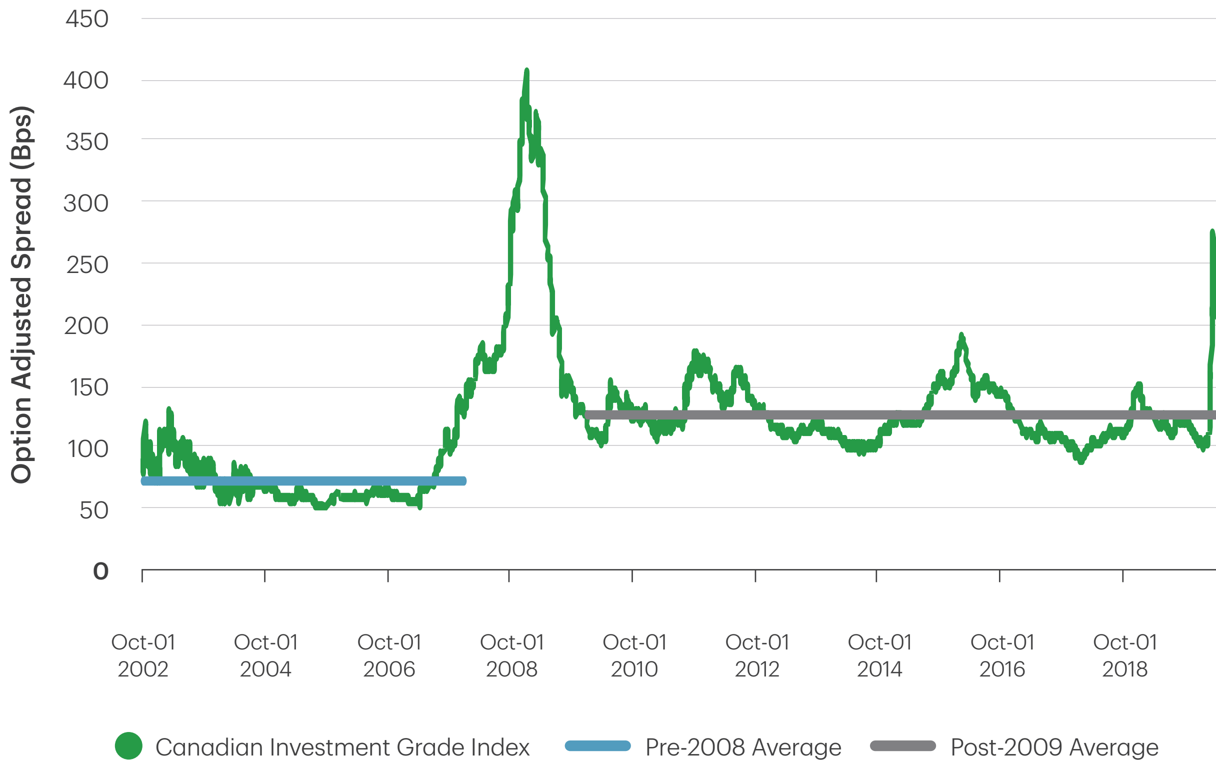
In Canada, over $110 billion in fiscal stimulus has already been pledged to consumers directly affected by the pandemic, while an additional $70 billion has been earmarked for lending directly to private businesses. On the monetary front, the Bank of Canada (BoC) has gradually lowered the policy rate, with the rate now 150 bps lower since early March as the BoC looks to support both the Canadian economy and financial system through the pandemic.

Beyond rate cuts, the BoC has also taken action to improve market functionality which exhibited a degree of inefficiency as volatility peaked in March. These actions taken domestically, when combined with policy actions taken around the world, lead us to believe that global political institutions will continue to take a “whatever it takes” approach to setting policy in an effort to alleviate financial and economic constraints from the virus outbreak.

In March of 2020, corporate bond spreads widened globally, as the expectations for a slowdown in economic growth and uncertainties surrounding the pandemic grew. The March corporate bond sell-off was one of the most rapid sell-offs exhibited in recent history. With the successful intervention by the BoC and the U.S. Federal Reserve (Fed), providing direct support to the corporate credit markets, we have seen corporate credit rally in recent weeks.

This intervention and support have allowed the functionality of these key funding markets to progress back to more normal levels, ultimately compressing credit spreads which peaked in late March. While we view this positively, the most important development comes with the improved functionality in the markets, which has allowed for fixed income investors to efficiently transact in the markets again.

Corporate investment grade spreads in Canada reached levels not seen since the Great Financial Crisis



Source: FTSE, as of April 15, 2020.

Development

Current opportunities in Corporate Credit

The recent dislocation in corporate bonds is a market occurrence that TDAM has navigated in the past. We have consistently utilized our credit and market expertise to determine if these occurrences are due to a deterioration in credit markets or attributable to systematic risk events. At this time, we believe the credit stress is driven by a systematic risk event, and we do not currently expect a significant deterioration in longer term corporate creditworthiness. For this reason, we view the current opportunity in the investment grade corporate credit market to be enticing, and believe it warrants a greater allocation to corporate credit at this juncture.

Relative to history, investment grade spreads have been extremely attractive over the last month, as credit spreads reached levels not seen since the global financial crisis in 2008. While value has been evident on an absolute basis, we note that the BoC has also pledged an exceptional amount of policy support to the investment grade corporate bond market, mainly through two facilities:

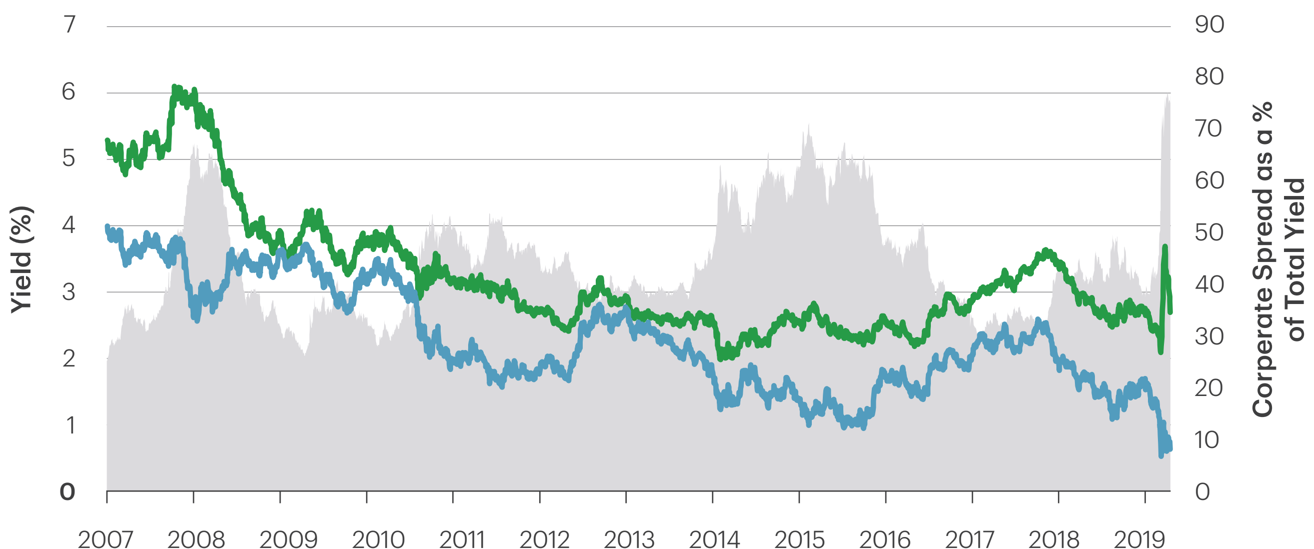
- **Commercial Bond Purchase Program,** that will purchase corporate bonds in the secondary market,
- **The Primary Market Commercial Paper Program,** that will purchase new commercial bonds issues in the primary market.

Given this unprecedented support, our belief that longer term creditworthiness should not show meaningful deterioration, and the relative attractiveness of corporate spreads, we continue to see value in corporate bonds even as the sector has rallied over the last month.

As we mentioned above, the reaction from global policy makers to counteract the negative economic headwinds associated with the COVID-19 pandemic included aggressive monetary actions. In Canada, these actions included cutting the benchmark policy rate by 150 bps, which in turn sent GoC yields meaningfully lower.

In the chart below, we highlight that in the most recent sell-off, the yield on Canadian investment grade corporate spiked to over 3.5% for only the fifth time this decade. Most notably, the most recent spike in corporate yields came when Government of Canada (GoC) benchmark bonds fell to the lowest level in over a decade. Given this dynamic, the spread component of the investment grade corporate yield is now around 80%, the highest level observed in quite some time, implying strong relative value for corporate credit. We believe the opportunity in corporate credit is further enticing given this yield dynamic.

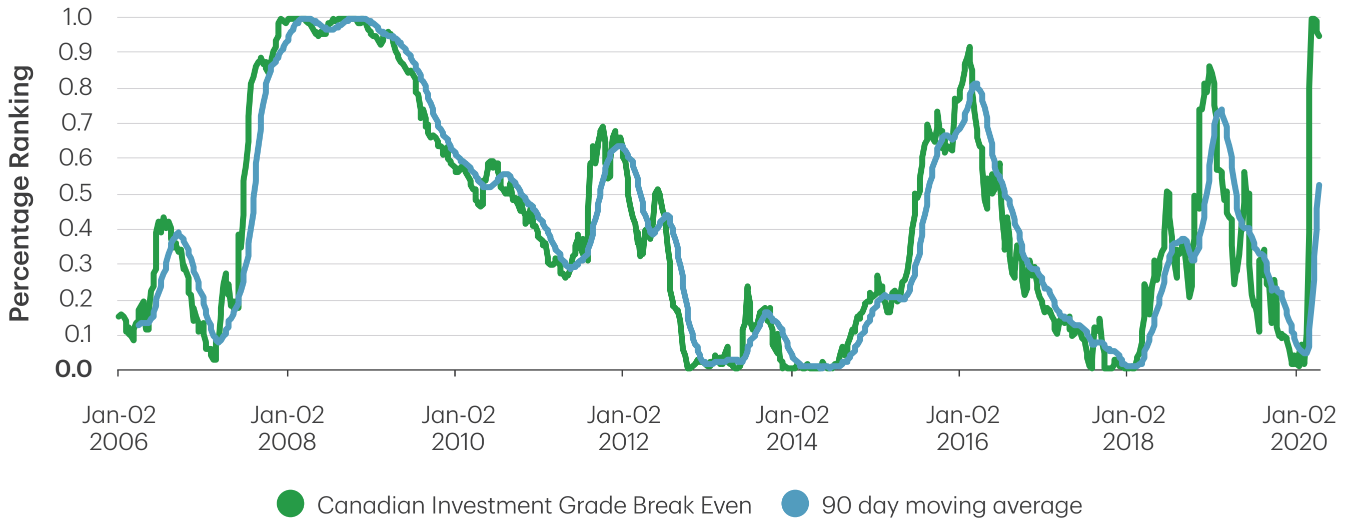
Canadian investment grade corporate bonds offer an enticing yield pickup over Government of Canada bonds



Source: FTSE, Bloomberg L.P., as of April 15, 2020.

One of our preferred valuation techniques is to look at the 12-month breakeven spreads percentile rank for each corporate credit, and compare this metric to the individual credit's longer-term history. This breakeven spread represents the basis point spread widening required for a credit to break even with a duration-matched position in Federal Bonds, over a 12 month time horizon. If we calculate this metric across the corporate investment grade market, we can see (in the chart below) that this measure on an index basis ranks in the 95th percentile, meaning that the corporate IG sector has only been cheaper 5% of the time since 2006.

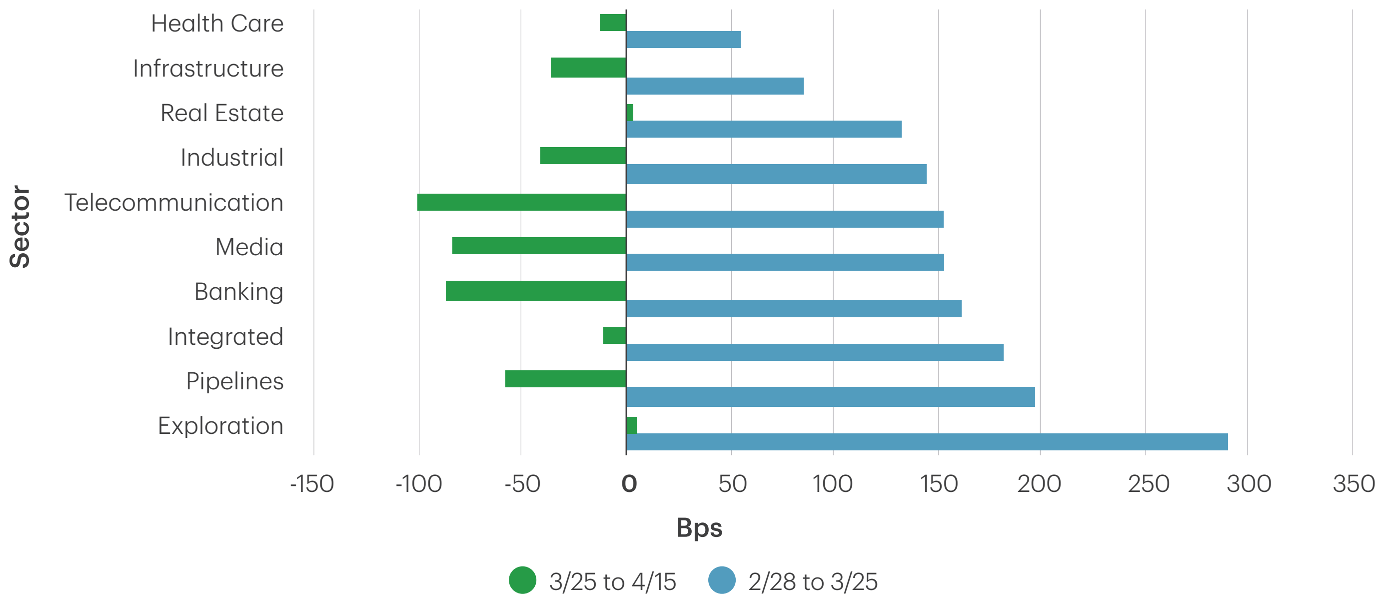
Canadian investment grade break even spreads imply strong relative value in corporate credit

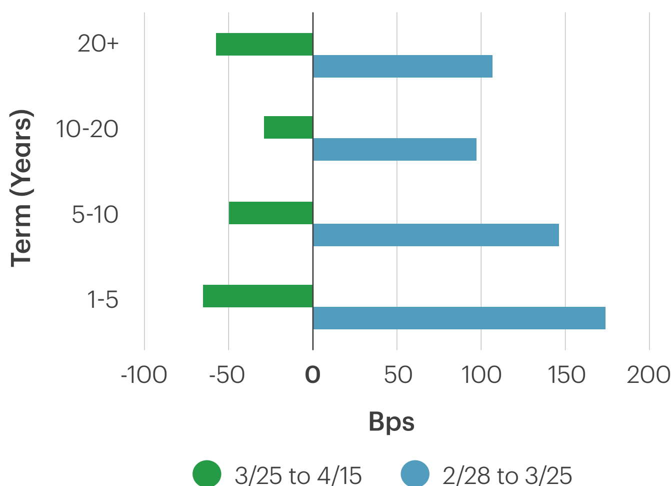


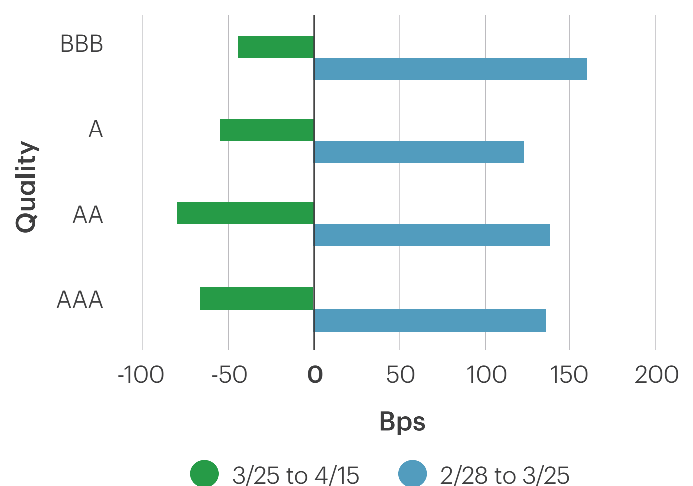
Source: TDAM, as of April 20, 2020.

Lastly, when we look at the March sell-off and subsequent rebound in the credit market, we notice that the sell-off was anything but orderly. The degree of spread widening varied significantly by sector, quality and term buckets, which you can see in the exhibits below. Market liquidity constraints created clear market anomalies, ultimately providing a canvas for a fixed income manager with credit expertise to outperform on. Some of these clearly observable market dislocations in late March included the underperformance of shorter-dated and higher quality credits, something that is not common during a period of sharp spread widening. When we look at the spread widening and subsequent rebound by sector, we also notice a varying degree of performance, allowing for an active reallocation of capital. As expected, energy credits underperformed in the sharp-sell off, as energy credits faced additional headwinds from meaningfully lower oil prices, though we see that the broad sell-off also pressured other sectors we believe have solid core fundamentals, ultimately presenting an opportunity to add credit exposure without taking on meaningfully more credit risk. By collaborating with out internal credit research team, we have been able to uncover these dislocation or opportunities in the market. In the next section, we provide an updated on specific market segments we see value in and discuss how we are actively taking advantage of these opportunities.

Sharp sell off in corporate credit created clear market dislocations







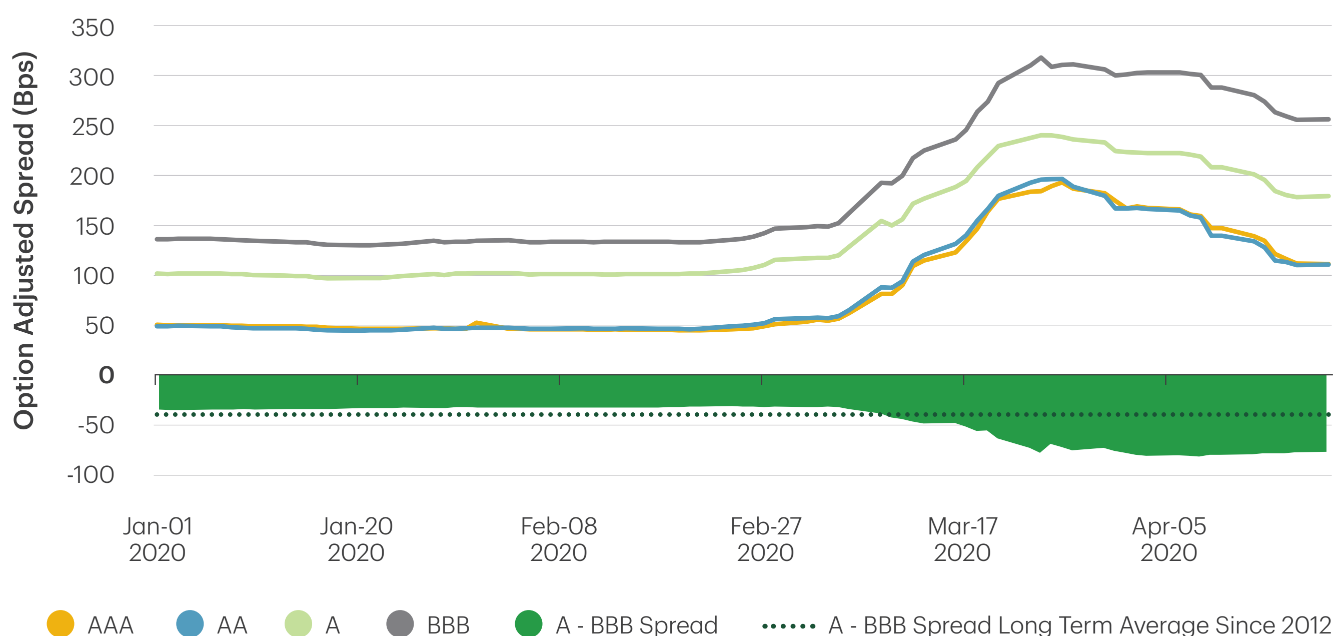
Source: FTSE, TDAM, as of April 15, 2020.

Relative Value in BBB Credits

Over the last few weeks, we have identified valuation shifts in the credit market, leading to a widening differential between quality buckets. Specifically, we see the sell-off in BBB rated credits as overdone, and as markets calm, we expect to see valuations trade closer to actual projected fundamental values.

As the spread between BBB and A-rated credit widened in the second half of March, we have been increasing our exposure to BBB corporate bonds in order to take advantage of the relative mis-pricing in the BBB-rated space. Over the past few years, BBB credits were viewed to be overvalued given that there was a limited spread differential between single-A and BBB credits. Our belief was that this limited differential did not properly reflect the additional risks in BBB credits, as BBB fundamentals appeared weak. For some time, we noticed that the BBB segment of the market saw leverage move gradually higher, as relatively low borrowing costs fueled a wave of leveraging M&A transactions.

BBB Credits provide attractive spread pickup when compared to the longer term average



Source: TDAM, FTSE, as of April 20, 2020.

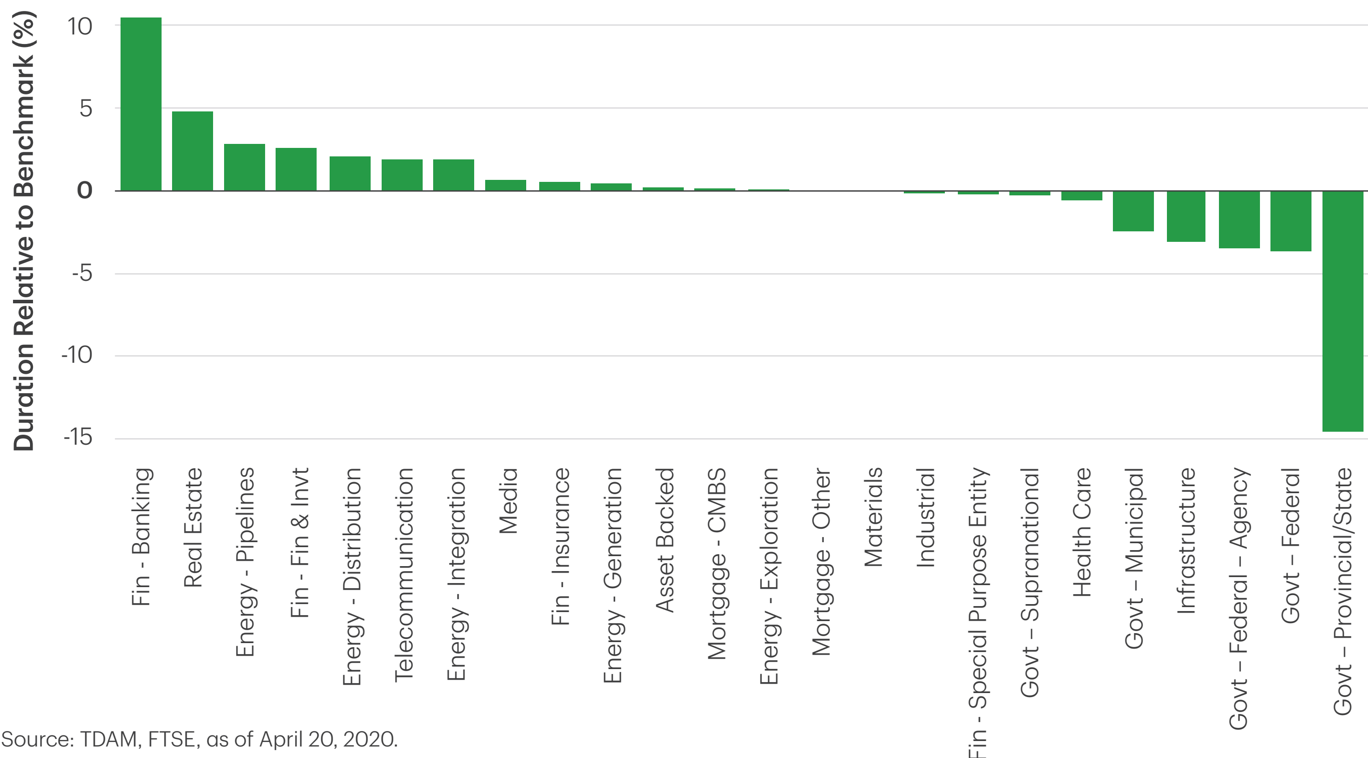
In 2019, we saw a reversal of this leveraging trend. In analyizing fundamental data and conducting bottom-up research, we observed that BBB-rated corporate issuers have for the most part addressed their balance sheet's and focused more proactivly on deleveraging. With the development of the pandemic, we expect M&A activity to remain subdued as corporations focus on internal stability, further removing the potential for elevated leveraging M&A activity over the medium term.

If we combine this fundamental development with the recent increase in the BBB / Single-A spread, we believe the relative attractiveness of BBB credits has significantly increased. For this reason, we believe that many attractive BBB opportunities exist, however, we remain focused on investing in quality issuers with solid business fundamentals, greater financial flexibility and management teams with strong commitment to their bondholders.

Opportunities

Sectors that can provide an attractive risk/return payoff

In light of the virus pandemic and subsequent market reactions, our credit research team has actively conducted in-depth studies on both individual credits and specific market sectors. These studies focused on identifying which sectors may have direct and secondary exposure to the pandemic and its effects on the economy, interest rates, commodity prices, supply chains and consumer behaviors. This work has provided us with the confidence to overweight sectors that can provide an attractive risk return payoff, as shown in the chart below.



Source: TDAM, FTSE, as of April 20, 2020.

We see relative opportunities in the pipeline, bank and telecommuncation sectors, as they can provide an attractive risk return profile at this time. Pipelines in our opinion are the safest sub-sector of the energy related segment, as most of the credits we invest in have strong contractual structures that limit cash flow variability. We note that pipelines do carry tail risk, which would be the case if commodity prices stay sustainably lower leading to longer-term counter party risk. We believe we are not quite there yet, and this should take some time to play out, providing ample time to identify trouble on the horizon if it should arise.

In telecommunication (telecom), we have seen limited impact from the pandemic. The telecom issuers have confirmed that they are being proactive by getting regular updates from suppliers and are increasing their communcations and marketing activity directed to consumers during the pandemic. The telecom industry is a unique industry, carrying high barriers of entry and limited competition. For example, in Canada, the industry benefits from a very favorable structure, with just three national incumbents (Rogers, Bell Canada and Telus) which account for 90% of the wireless subscribers. Given the scale of the “Big 3”, well over 90% of the Canadian telecom industry’s revenue and EBITDA are generated from these companies.

And lastly, we like the Banks. While all of the banks have secondary exposure primarily through lower interest rates weighing on profitability (net interest margins), we believe they are well capitalized to weather the current headwinds. We could also see lower loan growth and capital market activity impact profitability, but our opinion is that this would again only weigh on near-term operating metrics and would not create actual impairment concerns. In Canada, our six largest banks are domestically and systematically important banks, meaning they’re considered too large to fail and therefore face onerous regulatory requirements.

Utilizing market and credit research to win

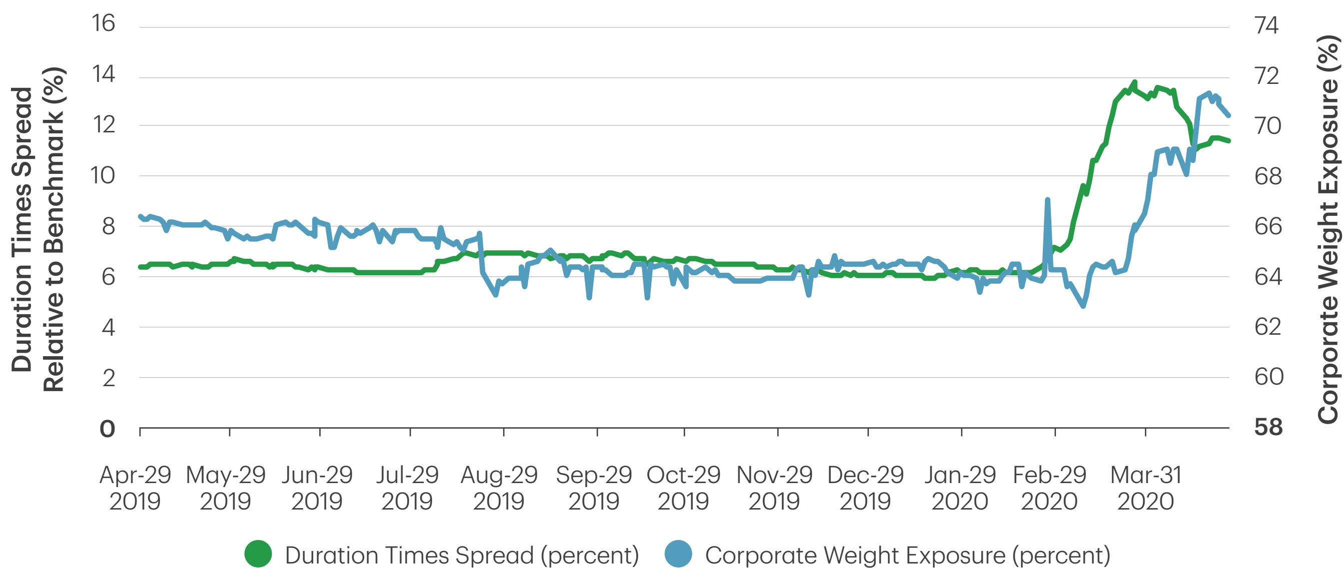
Our independent internal credit research has provided portfolio managers with a significant amount of additional information to help uncover market dislocations and allow for smart capital allocation decisions during this period of shorter-term economic disruption. This information allows TDAM to take advantage of oppourtunites in the BBB space and allocate to sectors where we see relative value opportunites.

As we look to increase our allocation to the BBB space, we continue to recognize the value add of our independent credit research team. We stress the word "independent", as the team is independent from both portfolio managers and public rating agencies. This independence allows for unbiased credit research, while also allowing for the team to project rating actions from public agencies before they happen. At this time, our credit research team regularly updates and maintains a "Fallen Angel Watch List", to identify credits with moderate to high levels of downgrade risk from the investment grade universe to high yield. The list uses internal fundamental projections under a variety of scenarios, which is then compared to fundamental metric downgrade thresholds provided by the public agencies. We believe this list allows portfolio managers to properly calculate if they are being compensated for the relative risk in a BBB credit.

The team also is regularly updating a "Sector Heat Map", which utilizes our proprietary risk score to identify how stable a sector has been and is expected to be. This sector heatmap provides portfolio managers with an internal opinion on sectors facing the greatest headwinds or tailwinds as we move into the post Covid-19 new economy. In addition, as we saw the potential for access to capital (through new issue markets) dry up as volatility started to rise in March, our research team ran extensive stress tests on our entire approved lists of credits. These stress tests were completed to identify credits with sufficient liquidity, both internally and through external lines of committed capital, to combat a prolonged business interruption. These special projects conducted by our credit research team helps ensures we are properly characterizing and communicating fundamental risk, to ensure the best outcomes for our clients as we move through these unprecedented times.

TDAM has taken action

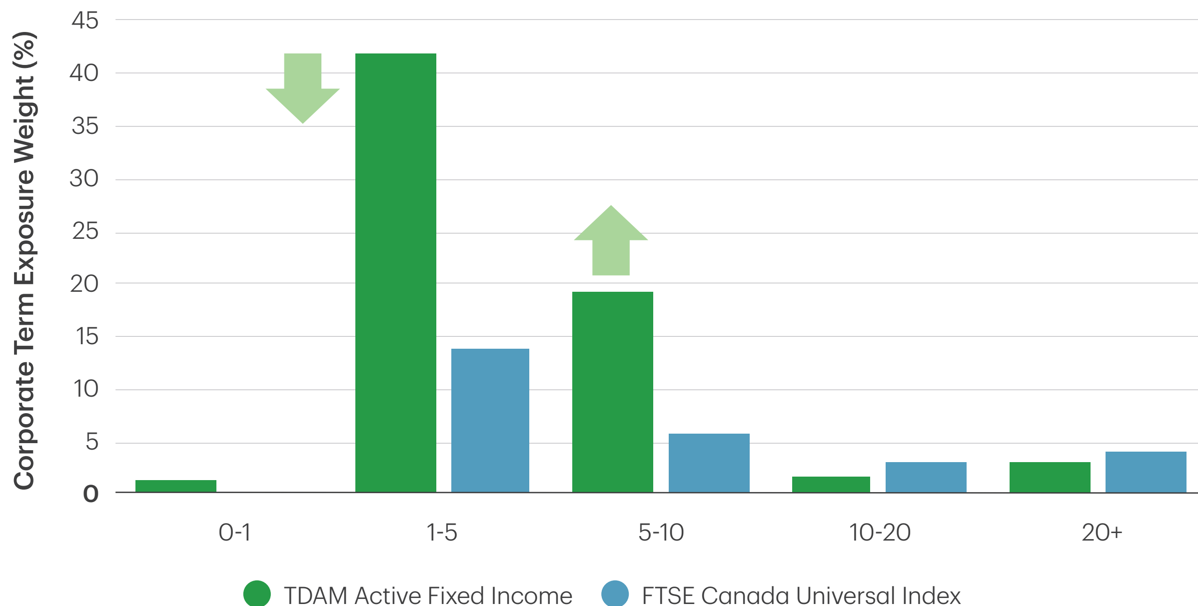
Given the opportunity to selectively add credit exposure that has been discussed above, we want to share how we are positioning our portfolio for an ultimate re-tightening of credit spreads. Duration times spread (DTS) is a measure of spread exposure in credit portfolios, as seen in the chart below, which is calculated by simply multiplying two readily available bond characteristics: the spread-durations and the credit spread.



Source: TDAM, FTSE, as of April 27, 2020.

In an environment where credit valuations are attractive, like we are in today, we would tend to increase our DTS versus the benchmark to take advantage of the expected rebound in corporate credit. As you can see below, we have been actively increasing this metric by adjusting our corporate term bucket exposure.

Tactically adjusting portfolios: Adjusting corporate term bucket exposure



Source: TDAM, FTSE, as of March 31, 2020.

With volatility subsiding and the BoC pledging their support to the corporate bond market, the new issue market has re-opened in a meaningful way. This has provided the opportunity for our investment team to increase their corporate exposure by implementing their high conviction ideas, some of which were discussed within this paper. The opportunity to tap the new issue market is even more significant during periods of heightened volatility, as issuers pay greater concessions to access the market. New issue concessions are essentially the “sweetener” or the extra yield issuers are willing to pay relative to their already outstanding bonds or peer group, in order to issue new corporate debt into the market.

It is times like these that TDAM can be a market maker and drive pricing, as corporations are looking to build liquidity ahead of relatively uncertain times. By utilizing our credit research team and the special projects they have conducted, as well as their proprietary metrics like risk scoring, we are able to conduct a thorough risk budget analysis for each new issue coming to market and determine if the compensation matches the identified inherent risks.

Seeking the best potential outcomes for our clients

Periods of rapidly changing economic outlooks leading to increased market volatility often lead to challenges and ultimately opportunities. At TDAM, we continue to utilize our analytical toolkit to identify relative value opportunities in the market and act on them accordingly. Over the recent weeks and months, our experienced credit professionals have worked diligently to help ensure the best potential outcomes for our clients. This work has included extreme levels of collaboration, as our credit research team continues to identify and categorize risk, while our portfolio management team prices that risk in the market. ■

Management

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