Investment Insights

SPRING 2018

Welcome to our series of observations on the Canadian credit market. This edition will provide some background on the characteristics of the market and reasons for institutional investors to allocate capital to credit markets in Canada.

Canadian Corporate Credit Market Overview

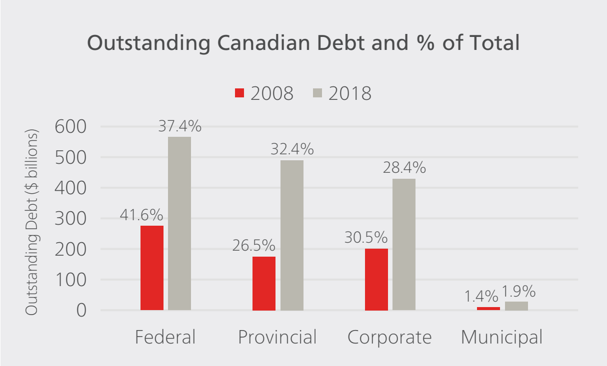
Corporate credit is an important part of the capital markets in Canada, facilitating the financing of balance sheets of Canadian companies and also offering investment opportunities for investors. The change in demographics, with baby boomers retiring, has impacted risk appetite and increased the demand for relatively safe and steady yield. Additionally, pension plans are converting from defined benefit to defined contribution arrangements and looking to reduce interest rate risk by matching future pension payments with assets that exhibit the same characteristics – namely fixed income securities.

Canadian corporations have been happy to meet this demand by issuing debt in order to finance share buybacks or increase dividends. Given the low level of interest rates that has existed in the past 10 years, Canadian corporations have taken advantage and have levered up their balance sheets. Based on data from FTSE/TMX, the investment grade corporate debt market for Canadian issuers has more than doubled since the financial crisis, currently with $429 billion outstanding compared to $201 billion 10 years ago.

Even with significant corporate issuance over the past 10 years, the corporate allocation in the overall Canadian bond market has actually decreased from 30.5% to 28.4% as provincial government issuance almost tripled.

As outlined in Exhibit A below, provincial bonds as a percentage of the overall market rose from 26.5% of the index in 2008 to 32.4% in 2018. Outstanding high yield debt issued by Canadian companies has surpassed the issuance in the investment grade market, almost tripling from a total of $29 billion in February 2008 to $83 billion ten years later.

EXHIBIT A



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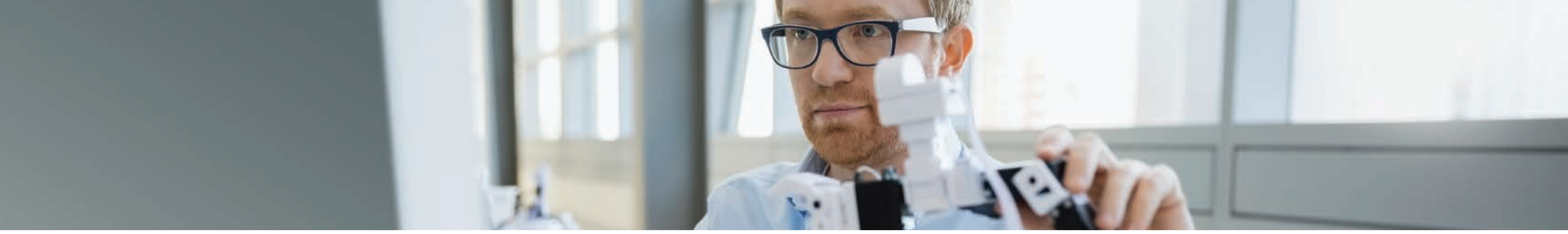


Investment Grade Corporate Credit vs Government Bonds

Corporate bonds are issued with additional yield (also known as spread) relative to government bonds in order to compensate investors for a higher risk of default. The level of that spread is influenced by a number of factors including the nature of a company's business, the balance sheet of the company and the general macro environment at the time. Spreads at the index level for Canadian investment grade credit have ranged from a low of 0.50% in the lead up to the financial crisis to a high of 3.5% at the end of 2008.

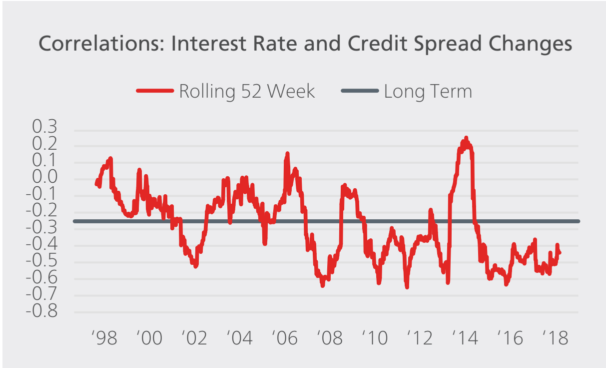
Given the additional yield that is awarded to owners of corporate bonds, it is no surprise that historical returns for corporate bonds have exceeded the returns generated by holding Canadian government bonds. Historical returns[1] from the FSTE/TMX Corporate Bond and Federal Bond Universes show that corporate bonds have provided investors with an annualized return of an additional 1.36% relative to federal government bonds. However, the additional return has not come with additional risk as measured by realized volatility. Volatility on the corporate index is actually 0.24% lower than that of the Federal Government index as highlighted in Exhibit B below.

EXHIBIT B

	Return	Volatility	Largest Drawdown	Worst Month	Best Month
FTSE/TMX Corporate Universe	5.83%	3.24%	4.06%	-2.18%	3.55%
FTSE/TMX Federal Universe	4.47%	3.48%	3.98%	-1.96%	4.00%

Why do corporate bonds that are generally viewed as riskier investments relative to government bonds have lower realized volatility? Diversification is the main driver of this phenomenon as corporate bonds have two components that are generally viewed to influence returns – interest rates and credit spreads. Interest rates typically move higher when the economy is doing well and central banks are looking to combat inflation. In this type of environment, it is generally viewed that companies are performing well and credit spreads tighten to reflect the reduced risk of a default.
As such, the two drivers of returns for corporate bonds typically offset each other and provide a smoother return pattern over time. This can be viewed in Exhibit C to the right, which illustrates the historical correlation between the change in credit spreads and the change in interest rates. Given the greater availability of data, we have presented information for the US market[2], however, the same relationship would apply in Canada. The negative correlation between the two drivers of returns for corporate bonds is evident in most periods and can explain the lower volatility relative to government bonds.

EXHIBIT C



Source: Bloomberg, ICE BofA/ML

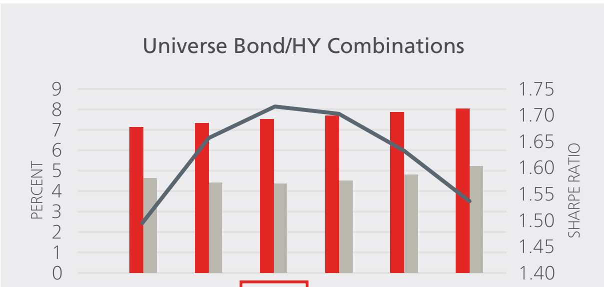
Benefits of High Yield in a Fixed Income Portfolio

High yield bonds are an intriguing segment of the fixed income market in that they have traditionally delivered equity-like returns with significantly less volatility. When looking at long-term risk-adjusted returns, the global equity market as defined by the MSCI World index in C$ has generated a Sharpe ratio of 0.57 as

[1,2] Data is from Jan 2001 to Feb 2018 and from Jan 1997 to Feb 2018. Change in interest rates is represented by the change in the 5Y US Treasury yield and change in spreads is represented by index spreads from the BofA/ML US Corporate Index

compared to a Sharpe ratio of 1.05 from the ICE BofA/ML US High Yield[3]. The attributes of high yield also make it attractive to combine with traditional Canadian fixed-income portfolios to not only generate additional returns, but to also reduce overall volatility. As outlined in Exhibit D below, a mix of 80% Canadian Universe bonds and 20% High Yield has historically provided an improved risk-adjusted return as it has increased annual returns by 38 bps and reduced risk by 26 bps[4].

EXHIBIT D



	100	90/10	80/20	70/30	60/40	50/50
Return (%)	7.14	7.34	7.52	7.70	7.87	8.04
Risk(%)	4.64	4.43	4.38	4.52	4.81	5.23
Sharpe (RHS)	1.54	1.66	1.72	1.71	1.64	1.54

Source: FTSE/TMX, BofA/ML, Bloomberg

Canadian Investors and High Yield Bonds

High yield bonds in the Canadian fixed-income market are relatively scarce as the majority of high-yield issuance in the North American market occurs in US dollars. Of the current Canadian companies that have outstanding high yield debt, only 12% of the issuance by market value has been issued in Canadian dollars with the remaining issued in US dollars. For Canadian investors interested in investing in the high-yield market, we would suggest that they take a North American approach in order to not only provide sector diversification but to also allow for a larger universe for security selection. The BofA/Merrill Lynch High Yield Canadian Issuers Index offers a universe of 70 companies with large concentrations in the Industrials (30%) and Energy (23%) sectors. This compares to the BofA/Merrill Lynch US High Yield Index, which provides the opportunity to invest in 884 companies with the largest single sector allocation at 15% for the Energy sector.

Single issuer concentration risk is also very high in the Canadian index given that Bombardier currently makes up almost 13% of the index. By incorporating US bonds into a portfolio, this obviously introduces foreign exchange risk and we would recommend that any currency exposure associated with the high yield bond allocation be fully hedged as currency volatility is actually higher than the volatility of the high yield bond index. In our experience, hedging USD is very efficient given the depth of the market and long-term performance leakage from eliminating currency risk has been insignificant.

Next Up

The next edition of our observations on the Canadian credit market will look at some of the current challenges facing fixed income investors and some suggestions as to how investors can best deal with these challenges.

Adam Bomers CFA, Portfolio Manager

We'd love to hear your feedback. For any questions or comments, please contact your Relationship Manager or Bryan DeLaurier (bryan.delaurier@scotiabank.com) at 416-365-2991.

[3] Data from Aug 1986 to Feb 2018
[4] Data from Jan 1990 to Feb 2018; FTSE/TMX Canada Universe and ICE BofA/ML US High Yield C$ hedged

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