Bloomberg

CIBC SEES CORPORATE BONDS REGAINING DOMINANCE: CANADA CREDIT

January 11, 2012

By Frederic Tomesco

Jan. 11 (Bloomberg) -- CIBC Global Asset Management is betting Canadian corporate bonds will post bigger gains than government debt in 2012 as economic growth slows for a second year.

Company notes are attractive because Canada's corporations have less debt and higher credit ratings than most of their global peers, said Jeffrey Waldman, who oversees about C$44 billion ($43 billion) as first vice president of fixed income at CIBC. Waldman likes "defensive" issuers such as Telus Corp., the country's third-largest phone carrier, and 407 International Inc., a toll-road operator, because of their relative lack of exposure to global markets.

Corporate bonds underperformed Canadian federal and provincial notes last year for the first time since 2008 as investors cut back on riskier assets while Europe's debt crisis intensified. Canadian corporate debt returned 7.9 percent, trailing the 9.6 percent return of federal bonds and the 12 percent gain for provincial notes.

"Given the quality of the marketplace in Canada, we are positive in our outlook for corporates," Waldman said in a telephone interview from Toronto. "From a risk-reward standpoint, you can make a case that the risk with Canadian corporates has gone down from a balance sheet standpoint, and the reward has gone up."

Members of Canada's benchmark Standard & Poor's/TSX Composite Index have a total debt to equity ratio of about 73 percent on average, compared with 100 percent for companies included in the S&P 500 Index, data compiled by Bloomberg show.
Bonds included in Bank of America Merrill Lynch's Canadian corporate index have an average rating of A2, one level higher than the A3 average ranking of the securities in the U.S. Corporate Master Index.

Fewer Defaults

Canadian issuers are less likely to default on their debt than their global competitors. For the year ended Oct. 31, default rates for non-investment grade companies averaged 1.54 percent in Canada, compared with 1.85 percent globally, 2.03 percent in the U.S. and 2.64 percent in Europe, according to Moody's Investors Service data.

"Our corporations have done a good job managing the balance sheet," Waldman said. "One can say that the quality of corporate debt in Canada is relatively better than elsewhere."

Corporate bonds now account for about 34 percent, or C$15 billion, of the fixed-income assets that CIBC Global Asset Management oversees, more than at this time a year ago, Waldman said, declining to be more specific. The unit of Canadian Imperial Bank of Commerce, the country’s fifth-biggest bank, also owns C$21 billion of government debt and C$8 billion in money market securities.

Corporate Gains

Elsewhere in credit markets, the extra yield investors demand to own the debt of Canadian investment-grade corporations rather than the federal government narrowed to 179 basis points yesterday, or 1.79 percentage points, from 181 on Jan. 9, according to a Bank of America Merrill Lynch index. The so- called spread ended 2011 at 183 basis points. Yields rose to 3.38 percent, from 3.37 percent on Jan. 9.

Canadian corporate bonds have gained 0.13 percent since the start of the year, compared with a decline of 0.22 percent for Canadian government bonds, according to Bank of America Merrill Lynch data.

Yields on five-year Government of Canada bonds rose two basis points to 1.29 percent yesterday. The difference between yields on five-year Canadian government bonds and U.S. Treasuries of the same maturity widened by two basis points to 44 basis points.

Quebec Bonds

In the provincial bond market, relative yields were unchanged at 69 basis points yesterday. Yields rose to 2.53 percent from 2.5 percent. The securities have declined 0.28 percent this year.

Ontario sold an additional C$750 million of its 3.15 percent notes maturing in June 2022, bringing the total outstanding to C$3.25 billion. The securities were priced to yield about 87 basis points more than federal benchmarks.

Quebec issued an additional C$500 million of its 3.5 percent bonds due in December 2022, boosting the total outstanding to C$1.5 billion. The notes were priced to yield about 99 basis points more than federal benchmarks.

CIBC Global Asset Management’s “base-case” scenario calls for Canada’s economy to expand 2 percent to 3 percent this year, Waldman said. Corporate bonds will probably beat federal and provincial debt even if the economy contracts or expands faster than economists estimate, he said.

Spending cutbacks by various governments across the country will probably curtail growth, leading the Bank of Canada to keep its key interest rate at 1 percent, Waldman also said.

Tough Choices

Canada’s federal government is seeking to cut spending by at least C$4 billion annually as part of a plan to help return the country’s budget to balance.

“On the austerity front, we’re going to be joining the party in Canada at all levels of government, whether it’s federal, provincial or municipal,” Waldman said. “Tough choices are going to have to be made either on the revenue side or on the spending side. This will be a headwind on the economy, and it will keep rates in general low in Canada."

Gross domestic product will probably expand 2 percent in Canada this year, down from 3.2 percent in 2010 and an estimated 2.3 percent in 2011, according to estimates gathered by Bloomberg News. Growth is forecast to be below the 2.1 percent expansion in the U.S., Canada's largest trading partner, which takes in about three-quarters of its exports.

Canada's benchmark Dex Universe bond index will probably return "in the low- to mid-single digits" in a "slow growth" or recessionary scenario, and decline if growth exceeds economist forecasts, Waldman said. Corporate bonds will probably advance in all three cases, he said.

Incremental Income

"If we are wrong and there is backup in yields, the corporate sector will be able, with the incremental spreads, to offset that backup in yields better than some other sectors," Waldman said. "In the event of a backup in underlying yields, two things work in your favor with corporates. You have a little bit shorter duration, and you have this incremental income that's going to offset potential capital losses."

CIBC Global Asset Management is "underweight" provincial bonds, meaning it holds fewer bonds than its benchmark index, on concern that provinces such as Ontario could have its credit rating lowered, Waldman said. He declined to provide the exact percentage of assets invested in Canadian provincial bonds.

Ontario's rating outlook was cut to negative from stable on Dec. 15 by Moody's Investors Service, which cited concern that Canada's most-populous province faces increased risks meeting fiscal targets as the economy slows. The province's debt is rated Aa1, the second-highest ranking assigned by the New York- based company.

Potential downgrades "could have a negative impact on credit spreads, which on a relative basis could lead provinces to underperform the federal sector," Waldman said. "There's no doubt that all levels of government in Canada are going to be facing fiscal challenges."

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