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Corporate bonds could continue to do quite well

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When Montreal engineering firm SNC-Lavalin Inc. issued $750 million in bonds earlier this year, portfolio manager John Carswell was an eager buyer.

The purchase reflected his view that corporate bonds will continue to do well in the current economic environment.

Carswell manages bond portfolios for Montreal mutual fund company GBC Asset Management.

He was attracted by the 6.63-per-cent yield on the SNC-Lavalin bonds, which are financing the private-public partnership that will build the new MUHC hospital in the Glen Yards.

That makes for a quality bond at an excellent yield, he says, and a nice alternative to the current risks in the stock market

Corporate bonds have fared well this year even as stocks have sold off.

Rising bond prices have produced nice returns for investors: at GBC, for example, the corporate bond portfolio is up about 10 per cent year to date.

Carswell, who is president and chief investment officer at Canso Investment Counsel, doesn't buy the popular view that there's a bond "bubble" in the making.

He argues that in a weak economy, with monetary policy on hold and little immediate risk of inflation, bond prices will continue to do well.

As a holder of bonds at other Quebec companies, including Videotron and Cascades, Carswell believes companies are in good shape to withstand a possible downturn in the economy.

Corporate cash balances are "at an all-time high," he notes, and quality companies have solid balance sheets without too much leverage.

While defaults on corporate bonds in Canada have edged up slightly from previous years, the default rate remains quite low. Last year in Canada, there were nine defaults among issuers, but he expects that rate to fall in 2010.

"The consensus coming out of the recession was that there would be a lot of defaults," Carswell said. The general view was that "the recession was very severe and the banks were so battered that they would pull in their horns and it would be very difficult for companies to refinance."

In fact, what happened is that bonds became cheap. Despite the dire predictions that companies wouldn't be able to refinance after the credit crunch, most quality firms were able to do so.

While it's true that banks pulled back on lending, many companies were able to replace their bank debt with bond issues.

At the same time, investors who had been burned by the stock market crash were looking to protect their capital and income. As they came into the market, bond yields fell and bond prices, which move in the opposite direction to yields, began to gain ground, providing a nice capital gain to holders.

The result was the interest-rate spread between corporate and government bonds narrowed from about 4.5 percentage points to two percentage points, reflecting increased investor confidence.

There was a very strong market in new issues last year. "It's awful hard to go bankrupt if someone will refinance you," Carswell says.

So, how much life is left in the corporate bond market?

Well, many companies have restored revenue to pre-recession levels but the difference is that they have cut expenses and labour costs. "The average company is in very good shape," he says.

Coming out of the recession, many people overestimated economic strength and inflation, he argues. The consensus view was that all the money governments were pouring into fiscal stimulus would cause runaway inflation.

There's no sign of that yet. The economy is weak and each passing day seems to bring more signs that the U.S. recovery is losing steam.

"There's nobody in the central banks that wants to raise interest rates, unless there's inflation. We don't believe there will be inflation in the U.S. and Canada" in the near term, he says.

Carswell believes the government money injected into the economy went primarily to repair bank balance sheets, not into inflation-producing assets.

It all adds up to a favourable environment for corporate bonds, he says.

"If we're in a period of protracted weak economic growth, low inflation and low interest rates, the extra one or two percentage points on corporate bonds makes a big difference."