Strategic Income Call – 03/20/20

Philip Petursson – Market Overview

- Very atypical fixed income environment. Since March 9, treasury yields climbed off their lows:
- US 10YR hit 50bps low now at 91bps. 2 days ago was above 120bps.
- 2 possible contributors to fixed income volatility:
- bonds are source of cash for industry participants.
    - Excess leverage, margin calls. Short sellers needing to raise cash. Hedge funds turning to more liquid sources to meet margin calls
    - Redemptions of fund holders. Fund managers will tend to sell fixed income rather than their equities to meet redemption requests.
    - Ultimately, more forced sellers than buyers
- Element of foresight in treasury markets
- Future deficits by central banks. $3-4T of net new issues can push prices lower. Higher inflation. Currently only speculation, but considering its impact
- Widening in credit spreads normal in current environment
- Markets pricing in 50% default rates. Energy more prone to defaults. Many will survive this
- HY performed as we thought. 50% of downside of equities. Spread widening not result of default, but cash needs of investment industry. Not a corporate issuer problem.
- Still continue to favour high yield.
- When spreads > 800bps, HY has delivered positive returns after 12 months in 42 of 44 periods

Chris Chapman (Senior Portfolio Manager, London, UK)

- Temporary disruptions ie: reduction in liquidity, how markets transact
- When sellers forced to “sell what they can” and everything gets marked down
- Similar to 2011 – everything marked down without ever changing hands
- Results – a lot of positive response:
    - Material response from central banks on monetary and fiscal side. Not just scale but speed. Rapid policy response and rapid escalation of policy response.
    - Transition from uncertainty about containment to now flattening of curve
- Perspective has changed and response changing as well. Central Banks around the world to flood liquidity into market. Every Central Bank cutting rates across the board (Fed, Bank of England, ECB, in EM – Taiwan, Indonesia, Philippines). Aggressive and quick cuts across the world
- More QE and forward guidance. Leaving rates low, and setting tone for what markets can expect
- Bank of England increased QE by $200B. Increasing size and increasing the pace.
- Open swap lines internationally. Help to provide dollar funding to places that need it. Access to foreign currency. Facilitate dollar funding to domestic banks. Enhancements include extending the terms, better rates. On Thursday 9 countries participate in swap lines, EM, Australia, NZ, Singapore
- Lots of demand for dollars in times of stress
- Lots of fiscal stimulus to help small/med businesses. Tax cuts, loans, wage subsidies. Programs are big in size, very quickly. Willingness for Central Banks and governments to help bridge this disruption.

Chuck Tomes (Senior Analyst, Boston)

- Peak infection and death toll in North America still to be seen over next few weeks. But stimulus package will provide good tailwind. Recovery will be much quicker and greater
- Over next few weeks, protect as best as possible. Not much working currently.
- HY spread from 499 to 1000 as of today. IG spreads inside 100bps now 325bps today. Govt yields from 50 to 120 back down to 90. Volatility will continue.
- 4 out of the 5 largest spread widening moves on a daily basis in history, happened over the last 2 weeks.
- Important to have portfolio that have ample liquidity that can provide cash and to take advantage of opportunities going forward.
- HY, can get worst, but now pricing in 50% default rates. Not aggressively buying today due to volatility but not surprised to see more next few weeks and months into USHY and emerging markets
- Feels very confident with return profile going forward

Current positioning and outlook

- Still of view to be prudent. Finding balance between select yield safety
- Change in sentiment. market pricing currently hasn't seen economic data yet from covid19 impact
- 18% HY currently, but will likely increase. Likely not up to 40+% like in 2008 or 2009. Potentially ~10% increase.
- Potentially increase to EM allocation
- Duration this year 5.25 to 4.75. Potentially get back to 4 or lower depending on risk/reward.
- Currently 100% hedged back to CAD. Down to 50% hedge in early Jan when CAD was above 77c.
- Comfortable seeing a positive return for rest of the year
- Overall yield over 4.5% and potential to see yield increase further. Plus taking advantage of opportunities and spread compression.
- YTD performance is mark to market losses – comfortable and confident in allocation – going to be a massive opportunity to take advantage of significant mispricing – it's just being patient, don't want to get in too early, plenty of time to do it - continuous volatility over the next few months – but confident about return profile, could be better moving forward
- We want to have a balanced approach to managing risk. Can't take on too much right now – whether that be interest rate risk, currency, credit, and liquidity – because we just don't know when things will look better.

Q&A

1) Credit Stress? Will Companies be able to stay in good standing?

- In US – dry up of new issues in junk bonds and complete dry up in leverage loans
- Some new companies come to market in investment grade space
- Still ability for companies to have access to capital markets.
- Private sector purchases in Europe – ripple effect to pull spreads in and pumping in liquidity.
- Govts Participate in new issues
- Demand should help to contain pricing

2) **Mark to market – what does this mean?**

- What is most recent price of the bond?
- Similar situation in December 2018. Markets were under pressure and investors were exiting their FI and Eq positions in flight to quality.
- Liquidation – ppl are going to sell what they can sell (not what they want to sell). Not selling due to fundamentals, but in environment that is illiquid
- Historically, banks used to step in as a natural buyer of things that people are selling. They aren't allowed to do this anymore and take on that level of risk.
- Even if only a small value changes hands, traders pricing lower than fair value. All bonds in same issue gets priced lower.

3) **Pension Funds rebalancing in Q1 and impact**

- Pension funds may need to sell fixed income in order to rebalance back to their target equity allocation
- About $160B of global equity that needs to be bought before end of Q1. Signs this is already going on. Some contribution to fixed income selling

4) **Past few days Investment Grade was hit harder than HY**

- Yields continue to fall long term. Interest rate risk largest highest its ever been in historical basis. Spreads have widen out dramatically. Difficult for Investment Grade because duration is much larger than HY (7.5 vs 4 yrs)
- We can look at XBB to see how a high-quality portfolio is doing. Down 7% YTD (as of yesterday) – goes to show that typical strategies to protect are not working

5) **Today vs 2008 – what's different?**

- In 2008, specific segments of market had issues. Now, not the case. Not a situations where the banks are the problem, it is more widespread
- A much faster response today. This may be a lesson learned from 2008.

6) **Performance – The fund in 2008 had very strong negative correlation to equity market, what about this time?**

- 2008 plenty of days and weeks that did not provide negative correlation. Similar situation now, protect now and make necessary changes. The team is confident in the mandate's ability to recover and will be rewarded for it.
- With fixed income, get the yield throughout the course of the year. Underlying yield in portfolio is good

7) **Now Fed is at 0%, how to make money?**

- Fortunate to have many levers within the fund and can invest in anything and anywhere. Not limited to UST and govt bonds which may continue to have difficulty

8) **Receiving input from medical professionals?**

- The team started speaking to doctors and thought leaders early on. With Kisoo Park based in HK, we had a good understanding of the impact.
- We initially underestimated its impact on a global basis – but so did everyone else
- Once we understood the severity, we started making allocation changes.
    - Sold local denominated Brazil, Columbia, and Malaysian bonds – completely exited these positions
    - Made the move because they are commodity sensitive countries. The team thought that we'd see a reaction in their currencies first
- By exiting these positions, brought cash to higher end of 5%