Credit's Spring: Bright Sunshiny Day

April 2019 Commentary

"It's going to be a bright (bright) sunshiny day." — Johnny Nash

Executive Summary

- Dovish central banks, led by the Fed, continued to support credit performance in April.
- Better economic data, benign inflation, and a good technical set up were also helpful.
- We continue to see good opportunities in the BBB segment of the market – particularly in issuers that have communicated a commitment to deleveraging.
- In April we rotated into Canadian credit, that had lagged global market movements, and remained focused on floating rate notes that offered good value.
- We remain constructive on the outlook for global credit.

THE CURRENT RALLY LOOKS TO STILL HAVE LEGS

Much like Johnny Nash's 1972 classic *I Can See Clearly Now* it seems as though the dark clouds that had gathered over risk markets at the end of 2018, have cleared. With the arrival of spring, investors are increasingly embracing what is looking to be a brighter day for credit markets. Without question the early phases of the credit rally in January and February were reluctant ones. Investors increased their conviction in March and April.

We continue to believe that this credit market has legs. Having said that, we remain acutely aware of how much valuations have richened since the beginning of 2019. This has highlighted to us the need to prioritize liquidity, in the event we need to pivot and defend capital more vigorously. Still our observations of the global marketplace leaves us feeling that credit has room to perform. Despite the movement in spreads, we continue to observe and uncover attractive opportunities.

THE FUNDAMENTALS, THE TECHNICALS AND THE INTANGIBLES

Macro conditions in April continued to improve. March US retail sales jumped by the most since September 2017, while first time unemployment benefits filings dropped to a 49-year low - both suggesting that underlying US labor market strength remains intact. Adding to the constructive data, US inflation remained benign, printing modestly below consensus expectations with the core PCE deflator printing at 1.6% year over year (1.7% expected). With global inflation already low, this softer print cemented the narrative that the Fed would be on the sidelines for the foreseeable future and supported expectations for a steady interest rate environment. Away from the data, progress on China/US trade talks continued in April and Brexit risks moderated, or at the least got kicked further down the road. All of which were constructive.

The technicals continued to bode well for credit performance. Investment grade and high-yield fund flows were positive and stable in April. US Dealer inventories (13-month to five-year paper) have been increasing over the past several months. Having said that, on a relative basis, they remain light. This is a constructive technical in that it demonstrates dealers have room to buy and be supportive of the new issue market. New issue supply in April was relatively low. Investment grade supply was largely in line with expectations while high yield supply was about 10% less than market participants had expected. On a year over year basis investment grade supply was down ~19% while high yield supply was down ~14%.

Taken together: (1) positive and stable fund flows (2) relatively light dealer inventories; and, (3) relatively low supply – all helped produce a constructive technical backdrop in April. May is typically heavier on the supply side - ahead of the summer months. We will be watching to see how the market potentially digests any upside supply surprises and whether this has any impact on dealer inventory levels. Given the persistent demand for credit we've been observing, we do expect new issue supply to be taken well.

We continue to see attractive opportunities in the BBB segment of the market as the business model for many of these issuers is predicated on access to investment grade funding. We have been most focused on issuers who have communicated their commitment to deleveraging, or sectors where the competitive landscape clearly requires such a commitment. In April, many of these credits/sectors performed very well. The telecom sector was among the best performers with names such as AT&T and Verizon leading the way.

Canadian rotation and floating rate notes ("FRNs") were key themes. From a geographic and thematic perspective, we rotated into Canadian credit as Canadian spreads had lagged the broader move tighter seen in global markets. As April came to a close we began to take profit and take down risk as spreads compressed meaningfully and we rotated back into the US. Another area of focus for us has been floating rate notes where valuations, relative to comparable fixed term debt, continue to be attractive

FRN exposures that performed well in the month included U.S. dollar Royal Bank of Scotland, AT&T and Bacardi bonds. With respect to our rotation into Canada, we saw decent value in Canadian REIT paper. In particular, we felt Granite REIT 4-year bonds were offered at attractive levels, with some of the best credit metrics relative to its comps. Our Fairfax Financial and AT&T Maple bond exposures (foreign issuer offered in Canadian dollars) also performed well. Although our energy exposures do generally remain on the lighter side, we do like utility like energy names that offer value and stable cash flows. As oil rebounded in the month exposures to TransCanada Pipelines performed well, as did some of our core conviction exposures such as Athabasca Oil, which we believe will be deleveraging. Dragging on performance somewhat were some of our investment grade credit hedges.

THE OUTLOOK REMAINS CONSTRUCTIVE BUT WE ARE PRIORITIZING LIQUIDITY

Our outlook remains constructive. Global central banks remain dovish, or at the least steady; market technicals continue to look constructive; and, rates appear poised to trade in a stable fashion. This backdrop has investors once again reaching for yield and we are seeing more appetite for BBB credit risk and extension trades. For those BBB credits that remain focused on de-leveraging, and committed to retaining an investment grade rating, we believe there remains good opportunity. Away from this, front end corporate credit remains in demand. We are seeing some opportunity in longer dated credit as all-In yields are at attractive levels for longer dated liability managers.

The constructive tone is encouraging us to be opportunistic but cautious. We are mindful of how far spreads have travelled and that valuations are now less compelling than they were. We have prioritized liquidity across all of our strategies to be well positioned for a pivot should fundamentals, technicals, or market dynamics require it. There are intangibles that we simply can't model for: Trump, US/China trade developments, potential Brexit outcomes etc.- but we can and will adapt portfolio positioning to extract value and preserve capital as necessary. With this all said, we continue to see attractive opportunities and believe credit markets still have legs to run. The term "Goldilocks" is often overused - but without question - we do appear to be in a period of Sunshiny Days for credit markets.

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