Battling Macro Headwinds

Q3 2019 Commentary

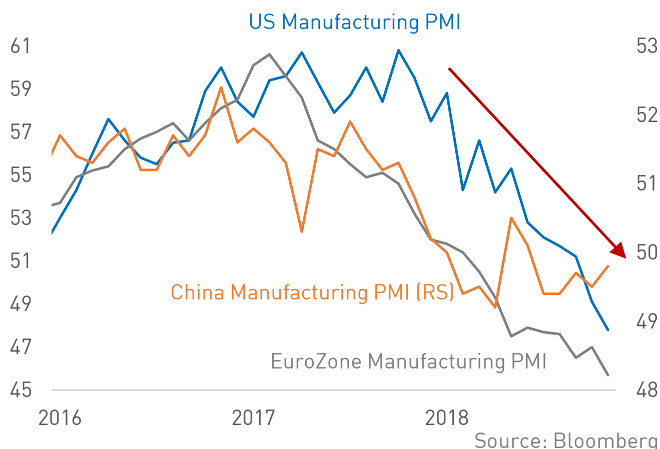
Executive Summary

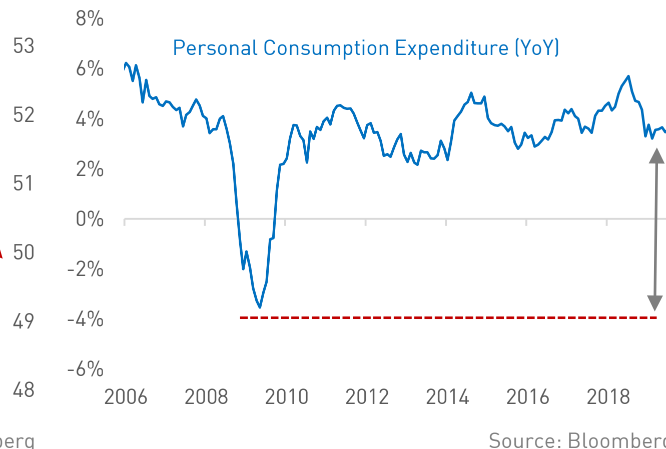
- Macro headlines dominated the quarter with continued focus on China/US relations
- We will continue to see monetary easing but don't think negative rates are coming to North America
- Repo-markets showed sign of stress but we are comfortable with the Fed's steps to backstop the market
- We continue to find corporate issuers that are fortifying their balance sheets for a possible slowdown ahead

For Q3 2019 most of the volatility was driven by macroeconomic headlines. China and Europe continued to show weakening economic data through the quarter which led to increased volatility in both geographies. In the U.S., manufacturing data also painted a less-than-rosy picture as ISM numbers breached important technical levels. Investors are now seeing the ramifications of trade conflicts in the real economy while each new tariff headline brings a new bout of volatility. While the slow down of key macroeconomic data means we are taking a cautious view of the market overall, one bright spot is the U.S. consumer. Consumer confidence and expenditures have been strong throughout the year, supported by solid income growth and low unemployment. The question on our minds is whether the U.S consumer has enough strength to carry the economy in the face of an increasing slowdown and Trump's evolving trade wars which could further impact the prices of consumer goods.

We believe the major central banks will maintain their easing trajectory in response to the continued slowing economic data we saw over the quarter. Perhaps the more important question is not "how much will central banks ease" but rather "what will the impact be"? We believe any incremental easing will have a diminishing effect as policy rates edge their way closer to the zero bound. However, we do not believe that monetary policy from the Federal Reserve ("Fed") and Bank of Canada will venture into negative territory as seen in Europe and Japan (we recommend listening to our recent webcast on the subject 'Are Negative Rates Coming to North America?' which can be found here). We argue that both Canada and the U.S. have key structural and demographic differences that make negative rates a less probable policy tool to be used by our central bankers.

Key Economic Indicators Continue to Weaken But the Consumer Has Been a Bright Spot





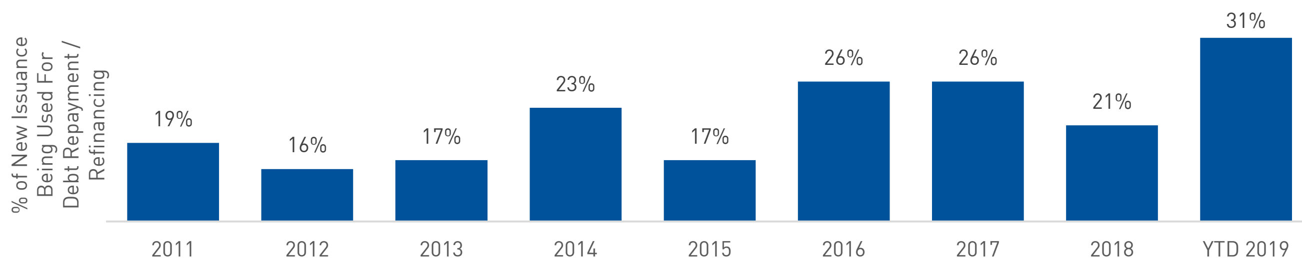
Against this backdrop of low yields and slowing growth we are still seeing strong capital inflows into North American corporate bond markets, specifically U.S. corporate bonds. This is understandable considering that 27% of global bonds still have a negative yield even after the back-up in interest rates we saw over the month of September. The hunger for any and all types of yield continues to benefit U.S. corporate bonds as increased inflows are leading to subdued volatility and decent liquidity in U.S. credit markets.

However, with the large amount of money chasing U.S. yields, dollar funding needs increased significantly in September which led to a spike in the repo-rate that captured everyone's attention. On September 17th U.S. repo-rates jumped to a staggering 10% from roughly 2% the week before. This sudden increase in the repo-rate raised eyebrows as people were reminded of the 2007/2008 financial crisis when similar shocks occurred as the liquidity in the system dried up. While we continue to monitor the situation closely, we think a few technical factors caused this spike (including tax payment due-dates for U.S. corporations and a large amount of Treasury issuance which hit dealer balance sheets – a confluence of events that led to a spike in dollar funding needs). We were glad to see the Fed quickly intervene in the market to help relieve any short-term pressures. More importantly, they have recently set out longer-term steps to help backstop the repo-market in case further pressures arise. At this point we do not see these intermittent spikes in the repo-rate as a "canary in the coal mine" for a possible liquidity crisis and the Fed continues to keep a vigilant eye on the market to ensure it operates as required.

While macroeconomic headwinds continue to call for cautious positioning, we are seeing some structural shifts which are constructive for corporate bond investors and this gives us confidence. Besides the additional demand which is helping to underpin corporate spreads in the U.S., we are also seeing further alignment between the interests of bond holders and equity holders. This is not always the case. In previous years most equity investors were demanding higher dividends and stock buybacks to boost equity returns. In the current environment we are seeing more equity owners think like bond holders – concerned for the financial strength of the companies they own rather than the outsized returns they can generate through financial engineering. This means that many of the issuers we own are now getting pressure from both us and our equity counterparts to ensure their balance sheets are strong enough to weather future downturns in the economy. Bank of America's Q1 2019 Fund Manager Survey shows that more and more equity managers are focused on "balance sheet management" over stockholder friendly actions – the number of managers who wanted to see companies "return cash to shareholders" dropped from almost 45% in 2013 to only 15% in 2019. This alignment of interests is also being evidenced in the new issue bond market. Year-to-date we have seen 31% of new issues proceeds earmarked for debt repayment or refinancing which will help lower leverage and interest rate costs for these issuers. This compares favourably to previous debt issuance which was commonly earmarked to boost dividends or buyback stock. From a portfolio standpoint we believe finding those companies who are taking these de-levering actions remain the 'sweet spot' for our strategies.

Facing ultra-low yields and a slowing global economy it is harder to find the 'income' in fixed income. Thus, we continue to manage our portfolios actively, investing in selective corporations which have shown increasing financial strength, underlying liquidity and a commitment to de-levering. We still believe this is the best course of action as we enter Q4, maintaining a defensive position given the likelihood of increased volatility going into the end of the year.

Increasing Amount of Corporations Issuing New Bonds to Pay Down Debt or Refinance at Lower Rates



Source: Goldman Sachs

Performance Commentary

RP Debt Opportunities

Credit spreads ended the quarter unchanged relative to Q2, however the journey to this point was quite volatile. Despite this volatility the RP Debt Opportunities Strategy posted a return of 1.54% over Q3. Most of this return came from both Short-Dated Income and Fundamental Value positions.

Many of the top contributors over the quarter included longer-term fundamental positions in companies where we see catalysts for value in sectors such as Financials, Energy and Healthcare. Within some of these sectors we decided to express our view via floating rate exposures to take advantage of a light new issue pipeline which caused secondary market spreads to move tighter. Floating rate positions in JP Morgan and Bayer were both larger contributors to performance over the period. Other contributors came in the form of Active Trading positions in Non-Bank Financials such as Cantor Fitzgerald and Citadel. The largest detractors from performance were credit hedges which we maintained to help manage downside risk against a volatile macroeconomic backdrop.

At the end of the quarter we maintain exposure to select BBB rated companies but with a focus on those issuers which have shown commitments to de-levering their balance sheets and who have multiple options to raise cash in the face of a possible slowdown in growth. The 5-year equivalent leverage metric for the portfolio remained consistent around the 1.6x level through the quarter.

RP Select Opportunities

The RP Select Opportunities strategy posted a 2.30% return for Q3. The strongest contributor to this return was our Fundamental Value positions which are comprised of longer-term holdings in issuers of which our credit analysts have identified a catalyst for upgrade or spread compression.

During Q3 we saw positive performance from sectors such as Financials and Communications. Our position in Sprint saw significant spread compression as the merger approval moved forward increasing the chances of our holdings being redeemed at a premium to where we initiated our position. We are also comforted by the fact that the company would likely see an upgrade even if the merger was to be blocked by government agencies. Other contributors included positions in Synovus Financial, Natural Gas Pipeline Company of America and an investment in Intelsat. The latter position was an interesting opportunity to invest in a lower rated issuer whose subordinated debt received large amounts of interest from high yield managers looking for outsized returns. We focused on positions in 1st lien and senior debt which still traded at attractive spread levels but had less underlying credit risk due to their seniority in the capital structure.

The strategy maintained a similar risk profile over the quarter, ending September with a credit duration of 3.9 years. Exposure across BBB and BB rated bonds ended the quarter relatively unchanged versus June 2019, however we did rotate holdings away from those names which saw significant spread compression to new issues which offered attractive spreads versus what was available in secondary markets.

RP Fixed Income Plus

RP Fixed Income Plus returned 0.61% in Q3, mainly through credit selection. The strategy outperformed the FTSE Canada Short Term Bond Index by 34 bps in the quarter and has now outperformed the index by 126 bps year-to-date. This was accomplished with less interest rate risk versus the index. A continued focus on opportunities in the U.S. bond helped the strategy capture excess return not available in domestic markets.

Top contributors to the fund included positions in select floating rate notes which saw significant spread compression while removing interest rate risk from the strategy. We expressed our view on longer term holdings by rotating a portion of the issuers fixed-coupon bonds into floating rate notes to capture the increase demand within the space. The Financials and Insurance issuers were both top contributing sectors. Detractors included positions in UK issuers such as AIB Group, Barclays and Santander UK as BREXIT fears impacted those holdings.

Geographic positioning over the quarter was relatively stable, while we did increase our holdings in Government and cash sectors near the end of Q3 as we took profits on individual bonds which saw significant spread compression. The overall corporate bond exposure of the strategy is 75% with the duration ending the quarter at 2 years. Credit duration ended the quarter at a similar level to where it was at the end of Q2, just above 2 years.

RP Strategic Income Plus Fund

RP Strategic Income Plus Fund ("STIP") returned 1.64% in Q3, helped by lower rates through most of the quarter and credit selection. Our exposure to select U.S. and European companies helped us outperform Canadian corporate bond markets while still hedging currency risk.

Like our other portfolios, the strategy benefitted by moving some exposure to floating rate notes which performed well on the back of a low issuance pipeline. Financials (Deutsche Bank), real estate (Senior Housing Properties Trust) and telecommunications (AT&T) sectors were all contributors to performance. Detractors included energy exposures (Bruin E&P Partners) and broad credit hedges which we maintain to preserve capital against a backdrop of macroeconomic volatility.

As of the end of the quarter the portfolio had a credit duration of approximately 6 years and an average credit rating of BBB+. Approximately 45% of the strategy's corporate exposure is invested in U.S. bonds (currency hedged) while interest rate risk was little changed over the period, ending at approximately 4 years. We continue to be selective in our credit positions with an eye towards corporate issuers that have a clear catalyst for spread compression and are taking actions to maintain healthy balance sheets and lower leverage.

	1 Year	3 Year	Since Inception*
RP Strategic Income Plus Fund – Class F	5.91%	3.50%	4.60%

*April 15, 2016

Important Information

Unless indicated otherwise, all returns, and portfolio data is presented as at September 30th, 2019.

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Strategy Performance

Strategy returns are in Canadian dollars and is net of all fees and expenses. Actual returns may vary from one investor to the next in accordance with the terms of the governing documents of relevant entities. Unless specified otherwise, returns presented for periods greater than one year are annualized. RP Debt Opportunities strategy returns are based on composite returns of RP Debt Opportunities Fund LP Class A and RP Debt Opportunities Fund Ltd. Class A, from October 2009 to July 2011 and RP Debt Opportunities Fund Ltd. Class A. from August 2011 onwards. RP Fixed Income Plus strategy returns are based on the weighted-average composite return of separately managed accounts utilizing a similar strategy from inception in July 2010 to April 2013 and linked to the returns of the RP Fixed Income Plus Fund Class A thereafter. RP Select Opportunities strategy returns are based on the weighted-average composite return of a separately managed account utilizing a similar strategy from inception in April 2014 to June 2014, and then linked to the returns of RP Select Opportunities Class A thereafter.

RP Strategic Income Plus Fund

Performance presented for RP Strategic Income Plus Fund is for Class F of the fund. Class F units does not include embedded sales commissions, which results in higher performance relative to Class A units of the fund. Performance data for RP Strategic Income Plus Fund is calculated in accordance with NI 81-102.

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