RPIA

Credit Market Themes in 5 Charts

Q3 2023

Challenges and Opportunities in a "Higher for Longer" Interest Rate Environment

Challenges and Opportunities in a "Higher for Longer" Interest Rate Environment

There continues to be plenty to talk about when it comes to fixed income! We haven't seen this level of curiosity from clients and prospects about bonds in several years.

Over the last quarter, investors continued to embrace the "higher for longer" narrative as optimism around falling inflation estimates was counterbalanced by some stubbornly persistent price pressures. Investors continue to grapple with the question of when and how yield curve normalization will occur. Front end rate cuts? Long end sell-off? Both? We expect continued volatility in yields as we progress through the balance of the year.

In the meantime, there is some good news! Despite disappointing recent performance for bonds, pension plans find themselves in an overfunded position for the first time in years. Many of these plans are looking to safeguard these gains by de-risking their plans further, which often means allocating more to fixed income. Foundations are able to invest capital in short-term bonds at the highest rates in over a decade. More broadly, fixed income now has a margin of safety not seen in some time. All of this bodes well for the asset class.

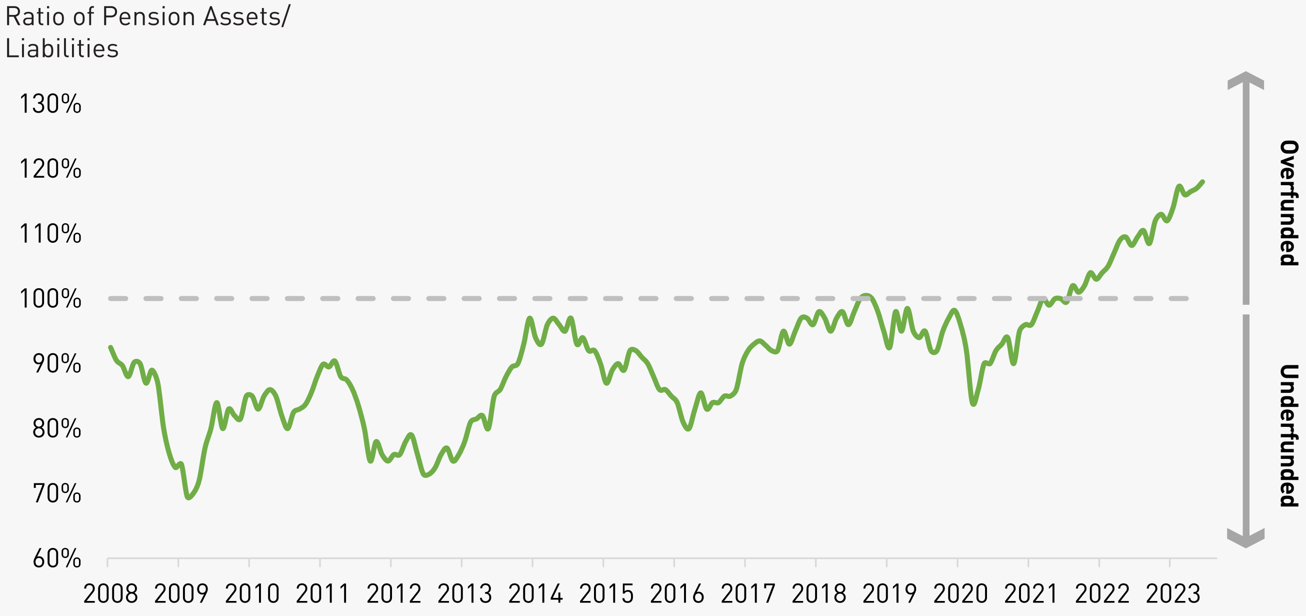
We continue to believe this is a market where caution is warranted and having a resilient portfolio is paramount. We believe active management can play an important role in helping achieve client objectives.

Please feel free to contact us if you would like to discuss further or learn how we could help you meet your risk-return objectives.

1 Overfunded Pension Plans May Want to Safeguard Their Position by Increasing Their Bond Exposure

Due to rising interest rates, Canadian pension plans are (on average) significantly overfunded. All plans should periodically review their liability hedge portfolio and reconsider the hedge ratio they are targeting – particularly after a dramatic change in funded status. We believe it may make sense for overfunded Canadian plans with a hedge ratio of less than 100% to increase their target hedge ratio by allocating more to fixed income. Within fixed income, we believe that credit can perform the valuable dual role of respecting the Plan's liability profile while also delivering additional returns from active management.

Canadian Pension Plans are on Average 18% Overfunded on a Solvency Basis



Source: Mercer. Data as of June 30, 2023. Index used for chart = Mercer Pension Health Pulse. The database contains information on almost 500 pension plans across Canada, in every industry, including public, private and not-for-profit sectors. The information for each pension plan in the database is updated every time a new actuarial funding valuation is performed for the plan.

2 We Believe Duration Exposure Can Once Again Provide Portfolio Diversification in a "Risk-Off" Environment

In the low-yield environment of the last decade, fixed income could only provide limited diversification benefits to a portfolio. With yields much higher today (10yr Treasury and U.S. Corporate Index at 4.9% and 6.0% respectively), we believe bonds can once again play the defensive role they performed in previous market corrections.

Bonds Historically Acted as a Ballast During Equity Drawdowns

Market Event	Period	MSCI World Return	10-Yr U.S. Treasuries Yield Level at the Start of the Period	Yield Change on 10-Yr U.S. Treasuries	Return on 10-Yr U.S. Treasures
Failure of LTCM	July 1998 - Sept 1998	-20.5%	5.4%	-1.3%	+10.7%
Dot-com Bubble	April 2000 - Oct 2022	-49.8%	6.0%	-2.6%	+21.9%
Great Financial Crisis	Nov 2008 - Feb 2009	-57.5%	4.0%	-1.6%	+13.6%
Eurozone Debt Crisis	May 2011 - Sept 2011	-21.8%	3.3%	-1.5%	+13.7%
COVID-19 Crisis	Feb 2020 - Mar 2020	-33.9%	1.5%	-0.8%	+7.8%

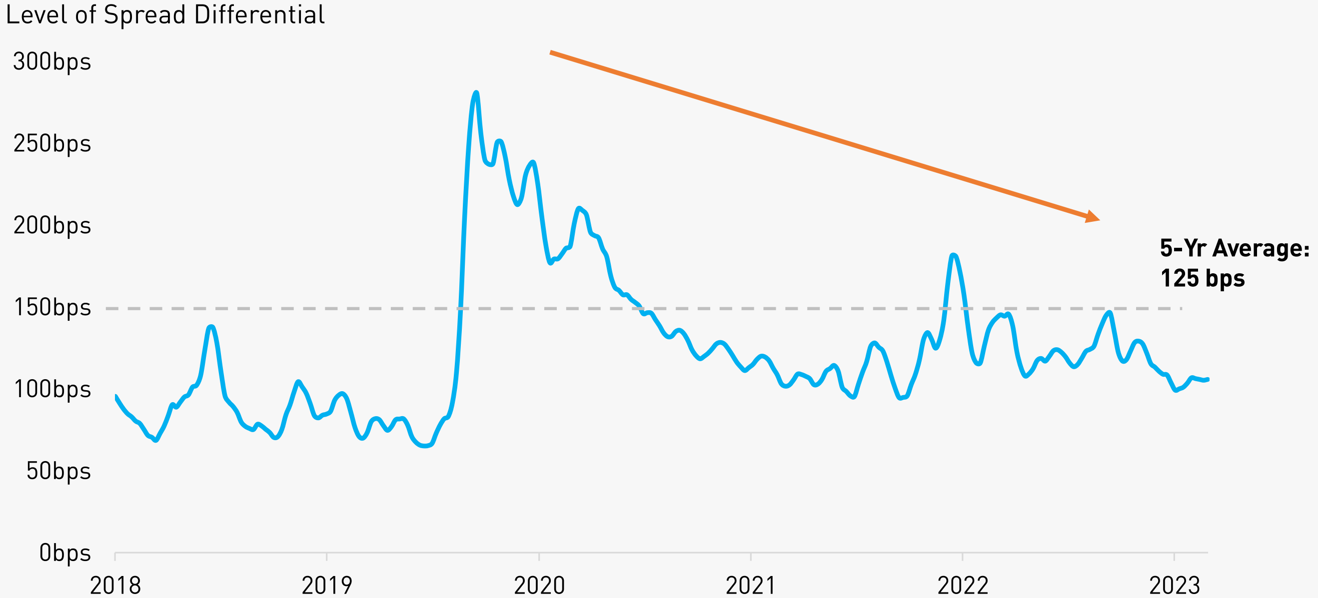
Data as of October 4, 2023. Source: MSCI, FRED. Index used: MISCI World Index (USD).

3 On Average, Investment Grade Credit Spreads Look Attractive Relative to High Yield Spreads

The additional credit spread earned from investing in BB-rated credits (versus BBB- rated credits) has declined from 270 bps to around just ~100bps since the COVID-19 crisis. Given the uncertain economic outlook, we believe it is prudent to invest higher in the ratings spectrum and focus on credits with stronger balance sheets.

If you combine the current level of BBB credit spreads with the elevated level of interest rates, the expected return converges on the long-term expected return of equities but with considerably less risk.

The Additional Credit Spread Captured by Investing in BB Bonds vs. BBB Bonds Has Been Shrinking

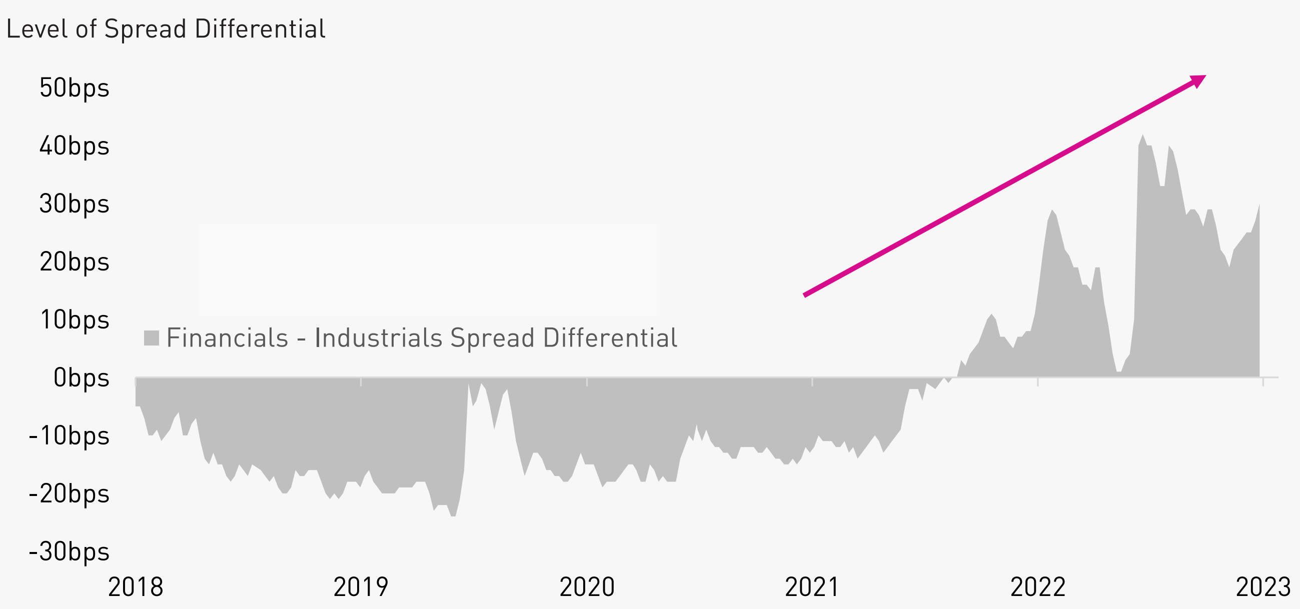


Source: Bloomberg. Data as of September 22, 2023. Index = ICE BofA BB/BBB US Corporate Index Option-Adjusted Spread.

4 We Still See Good Value in Financial Issuers Compared to Corporate Issuers - Especially "GSIBs"

Banks and other financial issuers experienced more credit spread widening than non-financial issuers following the failure of Silicon Valley Bank and the takeover of Credit Suisse. We continue to see value in financial issuers, particularly in Global Systemically Important Banks ("GSIBs").

OAS Differential Between U.S. IG Financials vs. Industrials - Past 5 Years



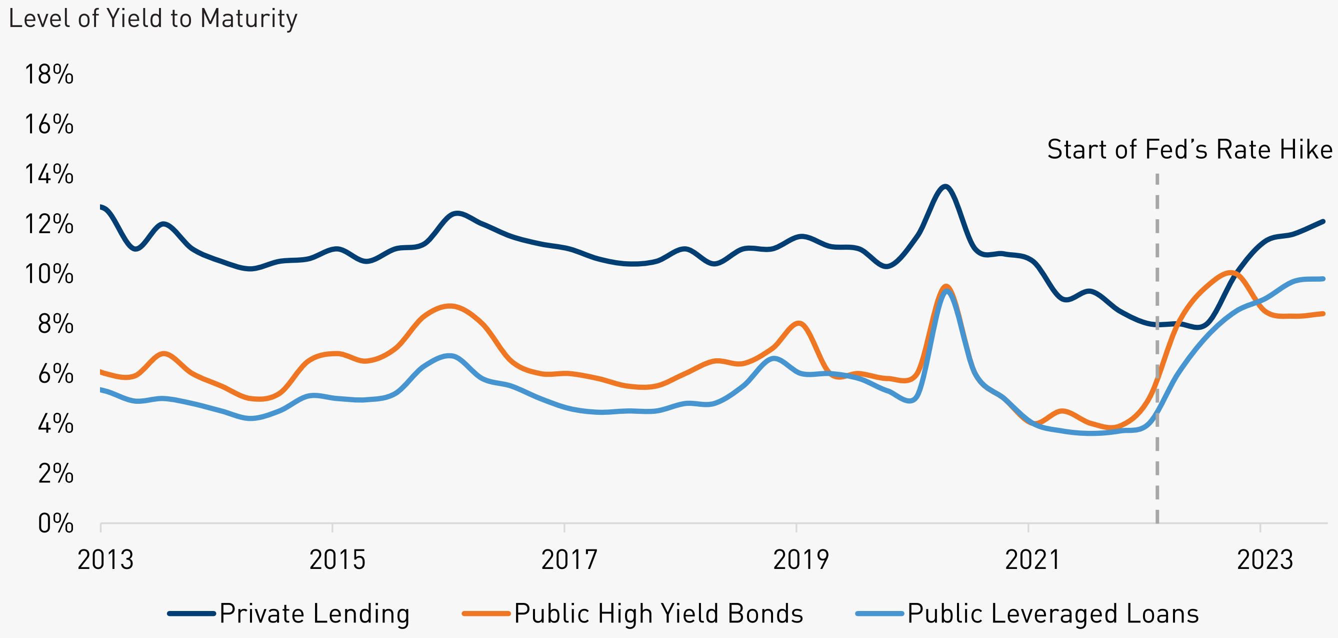
Source: Bloomberg, ICE BofA. Data as of September 25, 2023.
Financials Index Spread = Bloomberg US Aggregate Finance Avg OAS (LUAFOAS), Industrials Index Spread = Bloomberg US Aggregate Industrials Avg OAS (LUAIOAS).

5 Public Credit Valuations Have Increased to Levels Similar to Private Credit Valuations

Public credit investments like high yield bonds and leveraged loans have repriced much more quickly than private asset classes despite the fact that direct lending generally references a floating rate of interest.

We believe CIOs should be focusing on portfolio resilience and - given similar yield profiles - leaning more toward liquid public credit rather than tying capital up in illiquid private credit, as liquidity is especially important in a volatile and uncertain investment environment.

High Yield Bonds and Leveraged Loans Offer a Yield Approaching That of Private Credit...but with Better Liquidity



Data as of September 29, 2023. Source: Bloomberg, Morningstar, Cliffwater. Direct Lending = Cliffwater Direct Lending Index; High Yield = Bloomberg Barclays US High Yield Bond Index; Leveraged Loans = Morningstar LSTA US Leveraged Loan 100 Index.

Important Information

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