RPIA

Credit Market Themes in 5 Charts

Q4 2022

50.153
14.25
658.48
-103.20
50.153
14.25
658.48
-103.20

A New Chapter for Fixed Income

2022 was an *Annus Horribilis* for essentially all publicly traded asset classes as central banks increased administered interest rates to combat inflation. Government and corporate bonds provided no diversification benefits for investors, who experienced negative returns from both their fixed income and equity allocations. Many strategies focused on private asset classes delivered positive returns, thanks to the fact that they are not required to value their assets as financial conditions change. Investors will no doubt have welcomed the positive returns, although questions arise as to how the underlying assets would be valued today given the sharp drops in valuations for publicly traded investments.

After healthy correction, we believe now is a good time to add high quality fixed income. On an absolute basis, yields – which provide a margin of safety to bondholders – are higher than they have been in many years. On a relative basis, we believe the risk-reward of fixed income is superior to that offered by both equity investments and private debt. Although we are likely in the early stages of a recession, credit fundamentals in many areas remain sound with financing needs for corporations low and leverage at manageable levels by historical standards.

Markets will likely remain volatile in 2023. Central bankers will continue to tighten financial conditions to fight inflation and the implications for asset valuations and the real economy remain uncertain. We believe active management will be critical in navigating markets as the year unfolds to not only deliver returns for investors, but also manage risk effectively.

2023 will be a new chapter for fixed income as we approach the end of central bank rate hikes and find many avenues for investors to potentially find great benefit in their fixed income allocation. On the following pages are 5 charts we believe sum up our market perspectives from 2022 and our outlook for 2023.We hope you will find them thought-provoking.

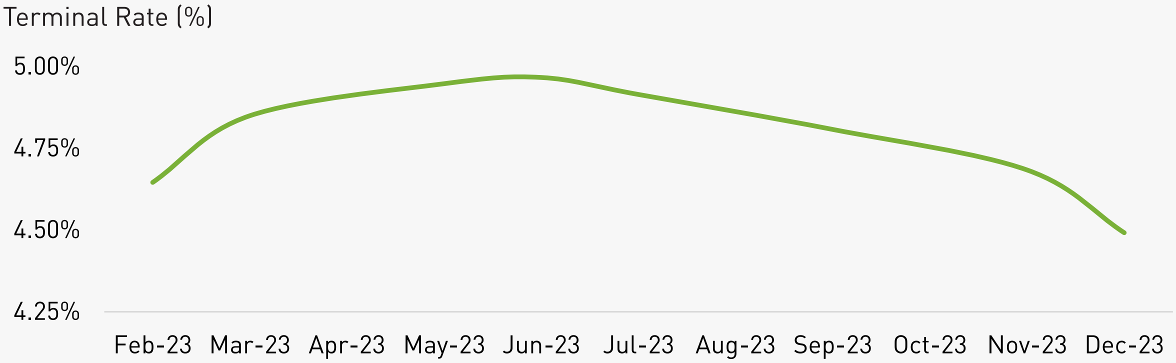
Please feel free to contact us if you would like to discuss these themes further or learn how we could help you meet your risk-return objectives.

1 Light at the End of the Tunnel

Historically, investing in advance of the final rate hike has generated strong returns

Sharply rising interest rates in 2022 meant the worst return for bonds in a century; however, we believe there is an opportunity going forward. Market pricing implies we will reach the peak overnight rate this cycle in mid-2023. Historically, investing in the bond market approaching this final interest rate hike has been a profitable strategy for investors.

Markets Imply US Interest Rates Will Peak at Around 5% in Mid-2023



Investing Near the End of a Rate Hike Cycle Produces Strong Returns

Rate Hike	First 12 months return (based on dollar cost average)	Annualized total return over five years
Jun 2006	4.5%	5.9%
May 2000	5.3%	7.2%
Feb 1995	7.7%	6.8%
Feb 1989	10.2%	10.6%
Sept 1987	7.0%	9.6%
May 1981	3.3%	15.6%

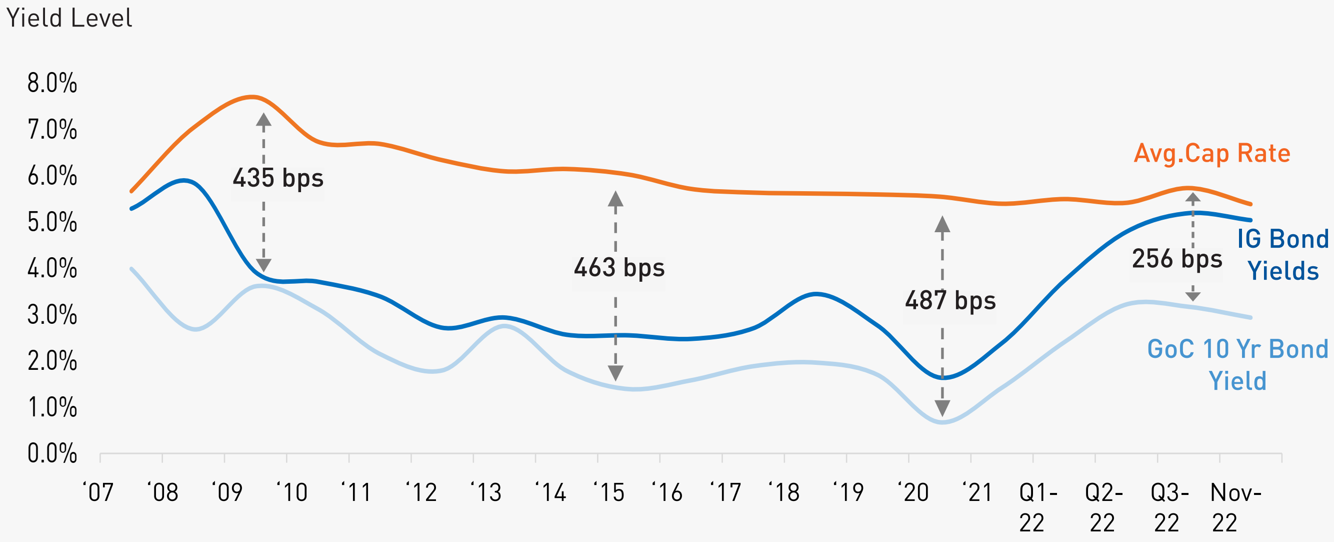
Data as of Jan. 6th, 2023. Source: Bloomberg. Index = Bloomberg U.S. Aggregate Bond Index.

2 Balancing Yield and Liquidity

Bonds can provide a yield competitive with real estate cap rates for the first time since the Global Financial Crisis

Over the last decade, investors moved away from traditional fixed income as part of the search for yield. A popular substitute for fixed income was real estate, with cap rates 2-3% higher than the yield offered by BBB-rated corporate bonds. With the interest rate increases of the last 12 months, we believe investors can now capture a yield on bonds that is basically the same as the cap rate on a real estate investment, but without sacrificing liquidity.

Bond Yields Rose Sharply This Quarter, Closing the Gap to the National All-Asset Cap Rate



Data as of Nov. 30th, 2022. Source: Colliers Cap Rate Report, Q3 2022, Bank of Canada and Big 6 Banks

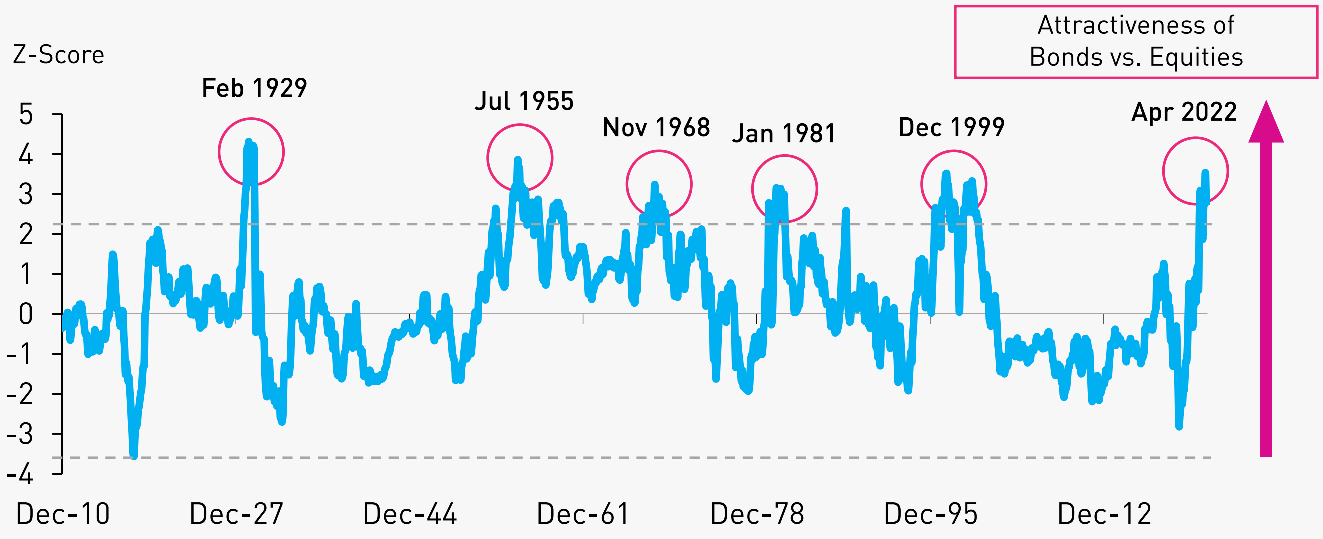
3

Credit vs. Equities

Bonds are the cheapest they have been to equities in 20+ years

The historical relationship between bond yields and the earnings yield of equities is 2-3 standard deviations away from the average. That is to say, from an income perspective, bonds are positioned much more favorably than equities. This disconnect has been driven by the dramatic increase in short-term interest rates, which means bond yields fall in the short-term, but could set the stage for higher returns in the long-term.

US Bond/Equity Yield Ratio (10 Yr Z-Score)



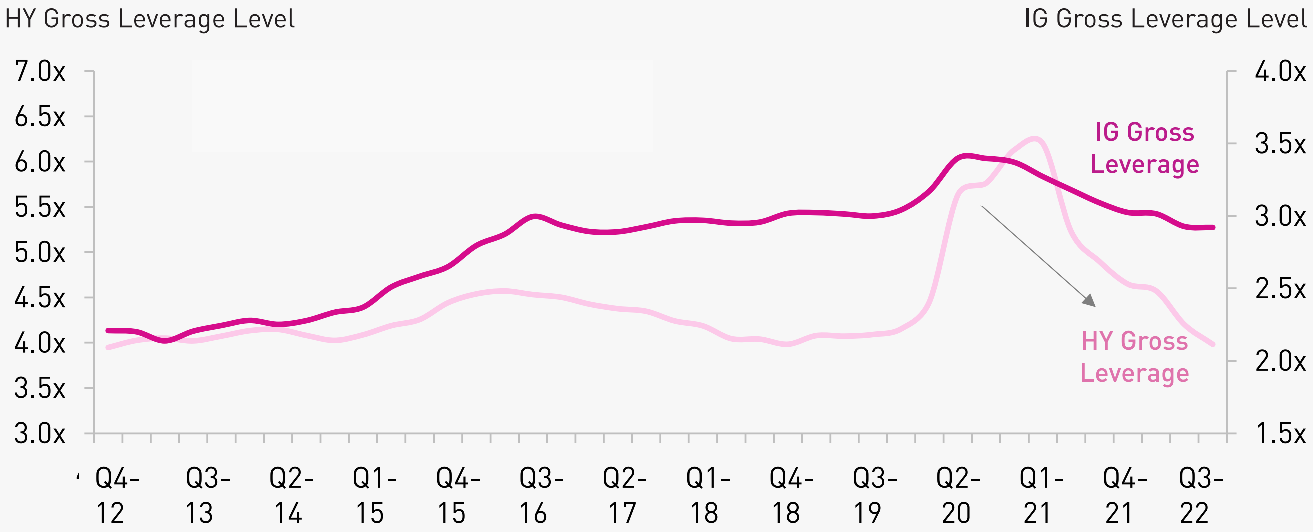
Date as of Dec. 30th, 2022.
Source: Absolute Strategy Research. US Bond Yield: Yield to maturity of 10-Year US government bond;
Equity Yield = Dividend yield of S&P 500. Z-Score is calculated as the observed value at any certain time point minus average of the dataset, divided by the dataset's 10-year standard deviation.

4 Issuers Prepare for a Slowdown

Corporate borrowers have reduced leverage, meaning they are better positioned for a slowdown

Since the COVID-induced market crisis of 2020, corporate treasurers at both Investment Grade (IG) and High Yield (HY) rated companies have reduced leverage. In addition, many companies took advantage of low funding costs to extend maturities and refinance upcoming debt issues early. As such, corporations, particularly IG-rated ones, are heading into a period of slowdown well-positioned to weather the storm.

IG and HY Companies Have Reduced Leverage in Recent Quarters - Meaning They Are Better Positioned As We Enter an Economic Slowdown



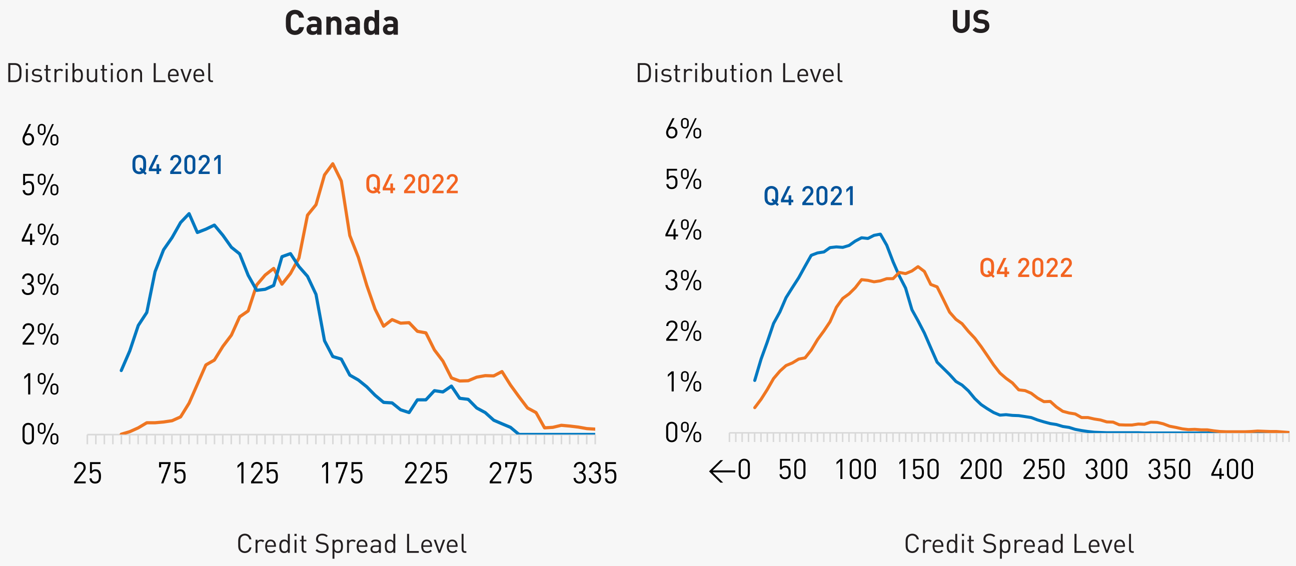
Data as of Sept. 30th, 2022.
Index = JP Morgan Global Credit Research Universe. Source: JP Morgan, CapitalIQ.

5 Better Opportunities

More dispersion in credit spreads means more opportunity from active management in Canada and the US

Given the mounting evidence of economic recession in the past year, credit spreads have widened across various markets and sectors. In addition, the spread differentials between issuers within the same sectors have also increased significantly. This wider range of valuations across the board can indicate more opportunities for an active manager to find relative value in corporate bonds through the security selection process.

There Is a Much Wider Range of Valuations in IG Credit Today Versus a Year Ago



Data as of Dec. 31st, 2022.
Source: Bloomberg. CA = Bloomberg Canada Corporate Total Return Index; US = Bloomberg US Corporate Total Return Index Unhedged USD

Important Information

The information herein is presented by RP Investment Advisors LP ("RPIA") and is for informational purposes only. It does not provide financial, legal, accounting, tax, investment, or other advice and should not be acted or relied upon in that regard without seeking the appropriate professional advice. The information is drawn from sources believed to be reliable, but the accuracy or completeness of the information is not guaranteed, nor in providing it does RPIA assume any responsibility or liability whatsoever. The information provided may be subject to change and RPIA does not undertake any obligation to communicate revisions or updates to the information presented. Unless otherwise stated, the source for all information is RPIA. The information presented does not form the basis of any offer or solicitation for the purchase or sale of securities. Products and services of RPIA are only available in jurisdictions where they may be lawfully offered and to investors who qualify under applicable regulation. RPIA managed strategies and funds carry the risk of financial loss. Performance is not guaranteed and past performance may not be repeated.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Indicated rates of return include changes in share or unit value and reinvestment of all dividends or distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder that would have reduced returns. Returns for time periods of more than one year are historical annual compounded total returns while returns for time periods of one year or less are cumulative figures and are not annualized. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. The compound growth chart is used only to illustrate the effects of a compound growth rate and is not intended to reflect future values or returns of the Fund.

The index performance comparisons presented are intended to illustrate the historical performance of the indicated strategies compared with that of the specified market index over the indicated period. The comparison is for illustrative purposes only and does not imply future performance. There are various differences between an index and an investment strategy or fund that could affect the performance and risk characteristics of each. Market indices are not directly investable and index performance does not account for fees, expense and taxes that might be applicable to an investment strategy or fund. "Forward-Looking" statements are based on assumptions made by RPIA regarding its opinion and investment strategies in certain market conditions and are subject to a number of mitigating factors. Economic and market conditions may change, which may materially impact actual future events and as a result RPIA's views, the success of RPIA's intended strategies as well as its actual course of conduct.

RPIA
Global Fixed Income Experts

RPIA

39 Hazelton Ave.
Toronto, ON
M5R 2E3

www.rpia.ca
General Line: +1 647 776 1777
Investor Services: +1 647 776 2566