Navigating a Steeper Curve

Q1 2021 Market Commentary

Executive Summary

- During the first quarter of this year, the "main event" was an increase in long-term interest rates and a steepening of yield curves.
- Steeper yield curves will benefit financial companies, and we are overweight this sector in our portfolios. We are cautious with A-rated corporate bonds given the incentives for management to sacrifice this rating.
- We continue to balance defensive investments with exposure to areas of the market where credit spreads have not fully re-traced to pre-COVID levels.

During the first quarter of this year, the major theme was the increase in long-term interest rates and a steepening of the yield curve. Despite uneven progress in vaccination efforts globally, investors continue to look through near-term challenges to an optimistic future. A reassessment of the outlook for inflation during Q1 led to a shift upwards in bond yields, particularly in regions where vaccinations are ahead of schedule and economic re-opening is already occurring. Given the profound effects of the pandemic, there will continue to be winners and losers. Companies are thriving or struggling based on the country or industry they operate in and the effectiveness of their response to the last twelve months' challenges. In other words, we believe it remains a market in which successful investment performance requires being highly selective and active.

As we noted last month, government bonds are not immune to dramatic price volatility. During last month's letter, we discussed the increase in long-term yields and its impact on the risk-reward relationship of traditional fixed income strategies. We believe that investors need to augment their fixed income allocations given the dramatic, secular decline in interest rates over the last thirty years. In this letter, we will highlight the impact a steeper yield curve can have on credit investments.

Financial companies should clearly benefit from a steeper yield curve, so we remain overweight in this sector. Under normal circumstances, we would expect a steepening yield curve to positively impact companies across sectors, but these are far from normal circumstances. Rising rates and a steepening yield curve result from changes in behaviour and are underpinned by the unpredictable environment created by the COVID-19 pandemic. As a result, we may see a less predictable impact on industries than we would otherwise expect based on historical examples. One sector that stands apart, however, is Financials. Regardless of the catalyst, a steepening yield curve will be significant to companies across the sector. Banks, brokers, and insurers stand to benefit from a steeper curve given the nature of the businesses. In essence, they borrow "short" and invest "long" and effectively collect a greater margin if the two rates diverge.

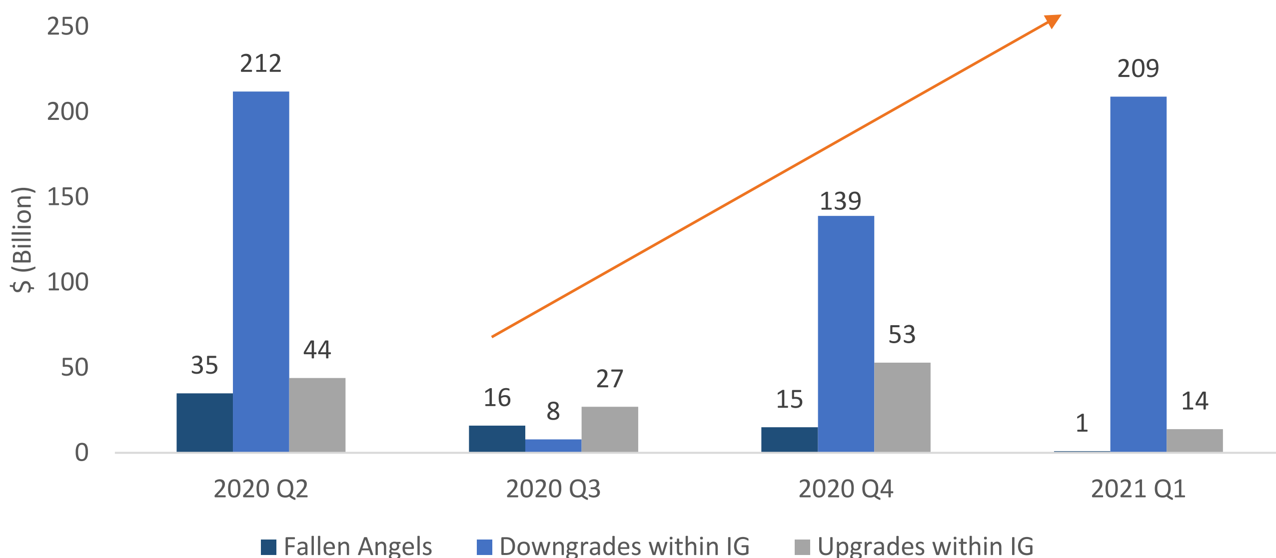
For REITs and mortgage lenders, a steeper yield curve will be a headwind, but it is important to consider the context. For REITs, the absolute level of interest rates matters most, and rates are still very low by historical standards. Similarly, mortgage lenders may see reduced refinancing activity

given a steeper curve while absolute rates remain low, which should be supportive of strong activity levels in both homebuilding and lending. In other words, a steeper yield curve does not benefit companies in these sectors, but rates are still exceptionally low in general which cushions the impact.

A steeper yield curve may lead to more corporate bond issuance as issuers move up planned deals to avoid higher funding costs later this year. As rates moved during the first quarter, we saw rate-sensitive borrowers such as utilities come to the market and direct proceeds toward various uses, including renewable energy projects. Other issuers who want to refinance expensive debt on favorable funding terms may come to the market earlier than expected to take advantage of current conditions rather than waiting to see what the second half of the year brings. Finally, while M&A activity was already expected to be strong this year, the prospect of a steepening yield curve may offer some additional incentive for acquirers to move forward on transactions sooner rather than later to avoid a higher cost of funding down the line. We will continue to be selective with our participation in the primary markets, focusing on transactions where the risk-reward is attractive.

We are vigilant with A-rated corporate bonds which may give management teams an incentive to prioritize shareholders at bondholders' expense. In general, the higher the credit rating a company has, the less the risk associated with their bonds defaulting. Or put another way, the lower the rating, the greater the chance you as an investor will not get your money back. However, ratings are not a certain guide to credit quality, and rating agencies have proven to be fallible in the past. In the current environment, companies can issue significant amounts of debt at a very reasonable cost. The appeal of this may be greater for A-rated companies than for BBB-rated companies. After all, A-rated companies have plenty of room to issue debt to take up leverage without jeopardizing the Investment Grade rating. Furthermore, they can do so with only a modest increase in their cost of funding. The proceeds of this debt issues can be used to boost shareholder returns in several ways, at the expense of bondholders.

We are cautious on A-rated corporate bonds in our portfolios as these companies are increasingly comfortable sacrificing this rating to maximize shareholder value.



Source: J.P. Morgan; U.S. Non-Financials ex. EM

We continue to balance defensive investments with exposure to areas of the market where credit spreads have not fully re-traced to pre-COVID levels. Valuations across all risk assets have increased considerably over the last few quarters. As evidence of this, average credit spreads, as captured by North American credit indices, are very close to pre-COVID levels. However, beneath the "average" number, there is a wide disparity between different sectors. An obvious example being mobility-sensitive or cyclical sectors such as Airlines, Hospitality, and Commercial Finance. Average credit spreads in these segments are still elevated. Taking a further look within these sectors, there is a wide disparity in the performance and pricing of different companies. Our focus has been to build resilient, defensive portfolios with select exposure to securities and companies that we believe offer attractive relative value. We see upside in these select exposures as vaccination efforts ramp up and as economies re-open. We believe this is the most prudent approach given the outlook and market pricing.

During March we saw an example of this from Oracle Corp who issued 15bn of bonds and saw their credit rating go from A to BBB. The proceeds of that deal were earmarked for a combination of stock repurchases, dividends, debt repayment, and future acquisitions. We expect this trend to continue and as a result, are careful with A-rated issuers where we believe shareholder interests may be pursued at the expense of bondholders. We prefer to focus on the BBB segment of the market, where the credit spread compensation is generally higher. Furthermore, because the cost of accessing the debt markets steps up materially for high yield borrowers versus Investment Grade borrowers, BBB-rated companies are highly motivated to act in a debt-holder friendly manner to preserve their Investment Grade ratings.

Thank you for your support. Please reach out to the Client Portfolio Management team if you would like to schedule a call to discuss our market views or your investments with us.

Important Information

Unless indicated otherwise, commentary, returns and portfolio data is presented as of March 31st, 2021. Index sources: Bloomberg & FTSE Russell.

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