Waking the Sleeping Giant

Q2 2023 Newsletter

Key Highlights

1. **Bond markets are extremely attractive** from an all-in yield perspective, and we genuinely believe that the current opportunity set in fixed income provides investors with an excellent entry point.
2. **It doesn't pay to go down the risk spectrum like it used to**, and we believe investment grade ("IG") credit is the optimal middle ground to generate higher yields than cash and treasuries without taking on undue risk.
3. **Valuation dispersion across and within asset classes** makes it a fertile environment for active managers to identify and exploit attractive pockets of the market.

Fixed Income is a Sleeping Giant

We acknowledge that policymakers are still in a somewhat precarious position given the unanticipated resilience of the economy and labour market. Nonetheless, we believe North American hiking cycles are imposing the intended effects. For instance, Canadian and US inflation measures are well off their highs and seem to be on an encouraging downward trajectory, while inflation expectations are well-anchored.[1] Additionally, there are segments of the economy that are flashing contractionary signals as the lagged impact of restrictive policy gains traction.[2]

Accordingly, we believe North American central bankers are likely near the end of their hiking cycles, which will support lower interest rate volatility even in a higher-for-longer rate environment.

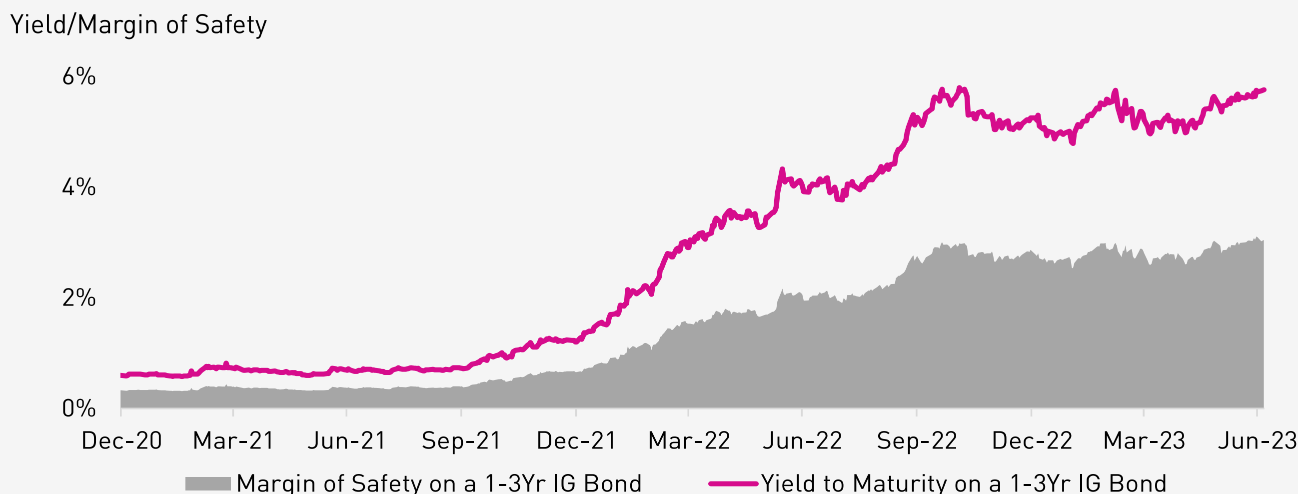
Where does this leave us as bond investors? Well, we have added moderate amounts of interest rate duration in our portfolios, with a particular focus on the front-end of the curve, to capitalize on the current opportunity presented by attractive all-in yields. And we genuinely believe that the current opportunity set in fixed income provides investors with an excellent entry point.

Higher is Better

All-in yields across the fixed income spectrum are attractive for the first time in a long time. For perspective, it wasn't long ago when corporate bonds provided meagre sub-1% yields. A couple of years later, on the heels of a historically aggressive rate hiking cycle, we can now source high-quality, short-dated bond yields in the 5.5-6.0% range.

An ancillary effect of higher yields is a greater margin of safety. Short-dated investment grade bonds can now withstand a 300bps or larger increase in risk-free rates and/or credit spreads before the total yield is eroded. This is a far cry from the paltry <40bps margin of safety the same segment of the bond market provided in early 2021.

Income is Back and the Margin of Safety is Substantial



Source: Bloomberg. Data as of July 5th, 2023.[3]

This yield buffer is a comforting concept that enables us to be more confident in our positioning relative to when yields were at the lower bound and the margin for error was negligible. As bond investors, we are always mindful of the global monetary policy backdrop, but we believe the time to increase fixed income allocations is now, regardless of how central banks behave over the rest of 2023.

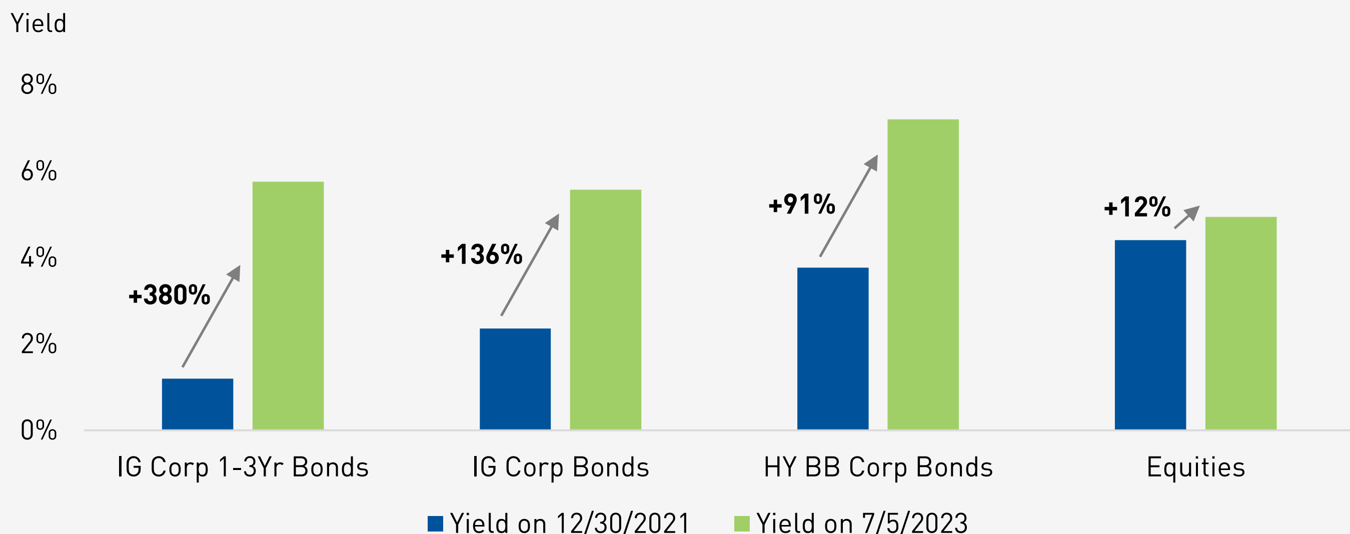
Taking a Tactical Approach is Important

For much of the last decade, investors were willing to migrate down the risk spectrum into lower-quality high yield bonds or equities to generate higher portfolio yields. But today, they have the opportunity to purchase higher quality investments to meet their income needs.

To illustrate the current opportunity, the chart below shows the relative yield attractiveness of investment grade bonds to the highest quality segment of the high yield market (US BB-rated bonds) and the average forward earnings yield of the S&P 500 equity index.

It also illustrates that short-term bonds, which generally carry lower default risk, all else equal, can provide investors with high quality returns while better limiting the risk of permanent loss of capital in the face of any future slowdown or recession.

The Revaluation of Risk Assets Highlights the Relative Value of IG Corporate Bonds (Change in Yields from 1.5 Years Ago)



Source: Bloomberg. Data as of July 5th, 2023. Yield = Yield to maturity for fixed income and the forward earnings yield for equity.[4]

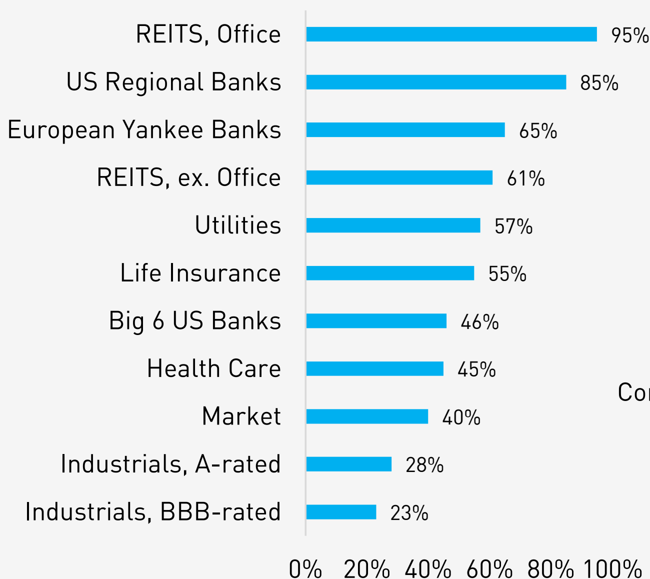
Diversify Income Generation with Corporate Bonds and Cash Instruments

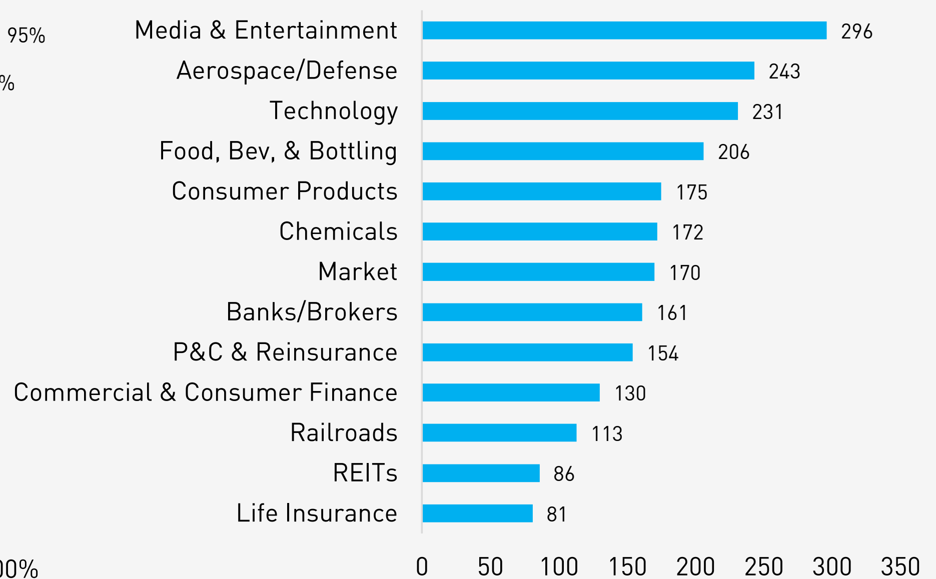
Given the substantial repricing in cash and short-term treasury instruments, it's not hard to argue that they can play a substantial role in creating better outcomes for investors. But in our view, receiving a yield pickup by investing in the highest quality companies in the world and a chance at creating additional value through active management is a sound strategy and well worth the incremental risk.[5]

We believe GICs and bonds can work harmoniously in a portfolio, with one providing safety from mark-to-market movements, while the other provides higher potential returns and capital gain opportunities to help offset future volatility in risk markets or equities in the chance of an impending recession. We wrote an article on the pros and cons of GICs vs. bonds that you can read **here**.

Knowing Where to Look is the Key to Generating Active Returns

We argue that investors can optimize portfolio returns by embracing a moderate level of diversified credit risk. A baseline yield of 5.5% is a great start, but as active managers focused on corporate bonds, we are tasked with identifying opportunities to generate alpha. Fortunately, another ancillary effect of higher yields is the uneven impact tighter monetary conditions have across sectors and the ample dispersion in valuations it has left in its wake.





Source: BofA Global Research, ICE Data Indices LLC. Data as of June 30th, 2023.

Recall, opting for a passive corporate bond strategy subjects the investor to index weightings that are often skewed towards the highest issuers of debt and without any regard to valuations or the economic backdrop. Is embedding index-level exposure to all sectors, including Media & Entertainment, the top year-to-date performer, or real estate, one of the worst performers, a prudent allocation decision at this juncture? To pursue such a strategy is to deny oneself the opportunity to exploit the most compelling risk-reward opportunities within the currently dispersed market.

In contrast, our active style enables us to allocate to the pockets of the market that best align with our risk-reward perceptions. We argue that active credit selection that relies on in-depth fundamental and relative value analysis to identify mispriced opportunities across all sectors can deliver considerable value to investors within the IG universe.

Final Thoughts

The restored opportunity in fixed income has been greeted with enthusiasm, and we believe there is untapped value beneath the surface. Valuation dispersion across and within asset classes makes it a fertile environment for active managers to identify and exploit attractive pockets of the market. We are excited about the current backdrop and remain committed to generating alpha for our investors in the coming quarters.

Please feel free to contact your Client Portfolio Management Team representative if you would like to learn more about how actively managed credit strategies can complement your investment portfolios.

Endnotes

[1]Source: Statistics Canada, Bureau of Labor Statistics, Federal Reserve Bank of New York, University of Michigan. The Canadian and US year-over-year May CPI readings sit at 3.4% and 4.0%, respectively, well off their June 2022 highs of 8.1% and 9.1%. Measures of inflation expectations, such as survey-based measurements and market-based breakeven rates, are also well off their highs.

[2]Source: Institute for Supply Management. Data as of 06/30/2023. The US ISM Manufacturing PMI, a key indicator that tracks US economic activity, is in contractionary territory and at its lowest level since May 2020.

[3]1-3Yr IG Bond Yield is represented by the Bloomberg US Corporate 1-3 Year yield to maturity. Margin of Safety on 1-3Yr IG Bond is for illustrative purposes only and is calculated by dividing the index yield to maturity by the index duration.

[4]IG Corp 1-3Yr Bonds = Bloomberg US Corporate 1-3Yr, IG Corp Bonds = Bloomberg US Corporate, HY BB Corp Bonds = Bloomberg US High Yield BB, Equities = S&P 500.

[5]Source: Bloomberg, ICE BofA. Data as of 07/05/2023. The yield on the ICE BofA US Corporate 1-3Yr index exceeds the yield on the Bloomberg US Treasury index by ~140bps.

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