RPIA
Global Fixed Income Experts

February 27,2020: What does the Covid-19 outbreak mean for credit markets?

The substantial rally in credit and equity markets came to quite an abrupt halt this week as concerns over Covid-19 spread to countries such as South Korea, Japan and Italy and fear of higher infection in the US has also increased. Notwithstanding these developments, we do not think the overall macro environment has changed in recent days – we still expect lower interest rates for longer, low global GDP growth, stable employment and household/consumer strength and solid balance sheet liquidity for the majority of companies. In addition, the flow of funds has been, and will likely remain, very supportive for credit markets.

Overview of current market conditions and what they mean for our funds:

- Equity market performance, with the S&P down 10.3% at time of writing in the last week, has begun to reflect the possible earnings impact to many global companies, which has so far not been factored into equity performance expectations by analysts.
- While the pace of the selloff in risk assets, including credit, has been substantial, we believe this may represent the beginning of a selective buying opportunity in credit.
- Correlation in the markets has been high, but we think many of the solid Investment Grade company spreads reflect some earnings and balance sheet pressure that may be caused during 2020 by the global impact from Covid-19. We are still exercising caution with regard to some weaker companies and some High Yield spreads that we already felt were too tight.
- Persistently low interest rates seem to be telling a different story than risk assets as the current levels are pricing in an almost certain interest rate cut by the US Federal Reserve in the near term, which we believe is still uncertain. Though we do not speculate on interest rate markets in our mandates, we have positioned our credit exposure to reflect our view that the rate market reverts somewhat and that investors are more comfortable taking credit risk once again.
- We have used the weakness of the past few days in credit to selectively add risk in bonds of companies that our investment team views as core and improving, primarily in USD where the risk-off tone has been much more pronounced than in Canada. However, we are seeing more companies become cautious on earnings growth expectations for the coming months, so are careful to analyze the risk reward proposition carefully.
- Challenging markets also allows RPIA to highlight our expertise in understanding and trading the relative performance of sectors, companies and capital structures across the currency markets in which we operate to optimize illiquidity in the markets and the behavior of less flexible investors. For example, we decided to improve the quality of the bank bond portfolio by reducing our exposure to

subordinated debt of Australian banks in favour of buying senior debt of the largest French banks at equivalent spreads.

- We specifically have added exposure to companies such as Bayer AG, Deutsche Bank, CVS Health, Abbvie, Barclays and Intesa Sanpaolo.
- The widening in credit spreads also allowed us to close some short positions we had on, in anticipation of a market widening, although we have not taken off all short positions. This volatility in the markets highlights the flexibility that exists in active fixed income portfolios.
- We remain confident in our return targets and view this as an excellent time to add exposure to our funds.
- Please contact the Client Portfolio Management Team if you have any questions or concerns. We would be happy to help.