The Signal and the Noise

Q1 2019 Commentary

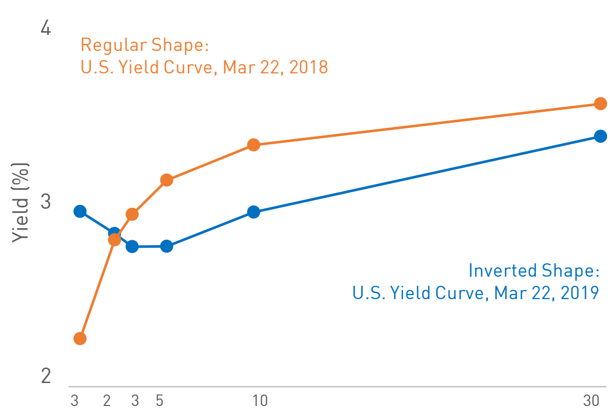
Executive Summary

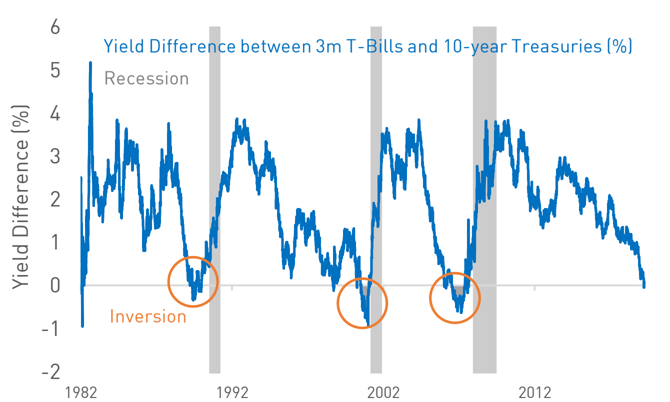
- 2018 saw investors struggle to reconcile slower economic growth with hawkish central bank signaling.
- During Q1, the Federal Reserve ("the Fed") capitulated to market stress and communicated a more measured approach to further interest rate hikes.
- Equity markets rallied and seem little affected by weak Q1 earnings – but the bond market is sending a different signal.
- While we believe recent yield curve inversion dictates caution, we don't believe a recession is imminent.
- We continue to see attractive opportunities within the category of BBB rated corporate bonds in North America.

The financial markets performed poorly in the final quarter of 2018 as nervous investors struggled to reconcile slower economic growth with the Federal Reserve's plans to continue to increase short-term interest rates. Something had to give – and in January it did with the Fed falling in line with other global central banks in communicating a more measured approach to interest rate policy. The change in stance was communicated by the Fed rather modestly announcing they would be "patient" in determining where further rate hikes would be appropriate. This adjustment was interpreted by the market as signaling that the rate hiking cycle is over – for the time being at least. Indeed, traders are now assigning a greater than 80% probability of U.S. rates being cut before the end of 2019. Investors welcomed this change in policy stance and, as capital was put to work, risk assets regained most of the losses they experienced in 2018. In spite of Q1 earnings being fairly weak, equity indices are back to where they were in October of last year - that is to say pretty close to all-time highs. Equity valuations are telling us that investors believe the weakness in earnings is a "blip" and underlying growth in the economy is still strong.

The bond market, however, is sending a different signal. During March the yield on 3-month Treasury Bills rose above the yield on 10-year Treasuries for the first time since 2007.

The yield curve inverted in Q1... which has historically been a precursor to a recession





Source: Bloomberg & NBER

Short term interest rates are generally tied to the overnight rate set by the central bank. Longer term interest rates are determined more by the economic outlook – when investors are worried about growth and inflation, they tend to buy Treasuries, which lowers the yield on these securities. For this reason, as longer-term yields fall below shorter-term yields, it is taken to be an indication that investors think a recession is on the way.

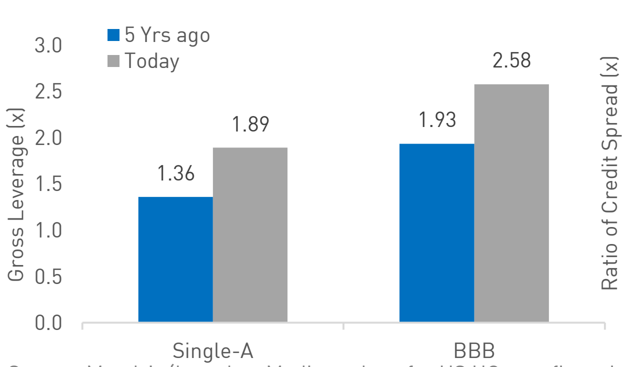
Granted, the "godfather of the yield curve" Campbell Harvey has found that only an inversion that lasts for at least three months is a reliable recession indicator. This inversion only lasted for only five trading days. Nevertheless, an inversion of the yield curve has been an accurate harbinger of recessions, preceding every downturn in the post-war period. This has prompted warnings that the U.S. economy might be headed for a recession later this year or early next year. Is the message from the bond market a genuine signal or merely noise?

While the flattening of the yield curve is not something to be dismissed lightly, there are some legitimate reasons why the signal may be distorted this time around. The U.S. government has been funding its deficit by issuing 3-month Treasury bills rather than longer-term bonds. This has pushed up short-term interest rates. At the same time there has been a flood of capital leaving Europe and Japan and being invested in the U.S. Treasury market, seeking a positive return. These funds have generally flowed into long-term bonds which has pulled longer yields down. As such, we believe the inversion is a reason to be cautious but not the beginning of the end. This has indeed been an extended expansion – the second longest in the post-war period – but we continue to believe the economic data from the U.S. is strong. Leading indicators also suggest that the Chinese economy may be picking up positive momentum once again. In other words, we're not as optimistic as implied by equity market valuations, nor are we as pessimistic as the bond market would suggest.

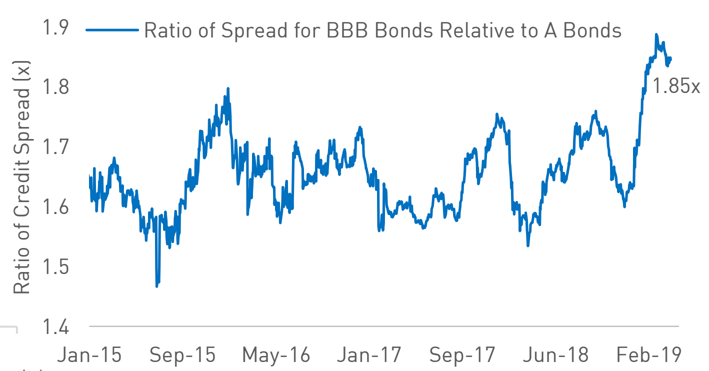
Given the length of the cycle there is no shortage of things to worry about – but one risk we do believe is overblown is the risk posed by BBB rated corporate bonds. Much has been written about the marked growth this cycle in companies rated at the lower rung of the investment grade ladder (now around half of the corporate debt market in both Canada and the U.S.). The fear being that when the economy starts to slow, a wave of downgrades would create a funding problem for these companies. Furthermore, these securities could potentially drop significantly in price because of the "indigestion" whereby the high yield market is unable to absorb that volume of debt in a short period of time.

Firstly, it is important to acknowledge that within the BBB space it doesn't really make sense to take a "one size fits all" approach. There are many companies in sectors where the ability to de-leverage is limited (beverage and consumer being a couple of examples) but there are also sectors where we believe there is the potential for positive ratings migration (for example, telecommunications and banks). It also matters the type of exposure you have as an investor – buying 2 year bonds issued by a BBB rated company can be much less risky than buying 10 year or 30 year bonds issued by the same company.

Companies of all ratings categories have added leverage this cycle... yet BBB rated companies have underperformed significantly



Source: Moody's (based on Median values for US HG non-financial issuers ex. Energy, Materials & Utilities)



Source: Credit Suisse (based on 7-10 Y Industrials)

That being said, we believe the risk of a wave of downgrades occurring in the near term is low. Downgrades generally accelerate during recessions, and as discussed we don't believe a recession is imminent. Although we are late in the cycle, central banks have effectively extended the cycle with their recent policy shifts. Eventually a number of BBB rated securities will lose their investment grade rating, we just don't believe it will occur in the near term, and we believe the downgrades will occur over time rather than overnight.

Furthermore, as the cycle has matured we have started to see the management teams of many BBB rated companies acting more conservatively – most notably in the most recent quarter. Many of these companies rely on access to the debt markets in order to finance their operations, and so they have adjusted their behavior patterns to ensure they can preserve their ratings. Many of these companies have reduced their hiring and capital spending plans. Others have been reducing dividends (for example Altagas Ltd, Anheuser-Busch InBev) and prioritizing deleveraging over mergers and buybacks (for example AT&T, Husky Energy Inc and Verizon Communications Inc). The same cannot be said for a number of A-rated companies, many of whom are still incrementally adding leverage and making acquisitions. More broadly, with the Fed's dovish pivot this year, we have seen global interest rates fall dramatically. As a result of this the yields available on corporate bonds in Europe are once more very low or negative. We believe this phenomenon should once again push foreign investors to "search for yield" in North America, and that this will further be supportive of BBB rated credit spreads in North America.

We will continue to look for undervalued opportunities in the BBB rating category and will employ a highly selective approach. We believe at this point in the cycle a nimble, flexible investment style makes sense – enabling us to respond to opportunities quickly and to quickly respond to changes in the macroeconomic backdrop. This cycle cannot and will not last forever, but central bank policy in Q1 extended the cycle further. We are pleased that against this changing backdrop we were able to add value for our investors.

We hope you have found this commentary useful and would welcome any comments or questions you have.

Performance Commentary – RP Debt Opportunities

With a pronounced compression in credit spreads, the RP Debt Opportunities strategy posted strong return of 3.46% during Q1. The sub-strategies that most meaningfully contributed to the return were Short Dated Income and Active Trading.

Many of the top performers during the quarter were high conviction investments in companies where we see long-term value – examples being Deutsche Bank, CIT and Anheuser Busch. Following the change of policy stance by the Fed we used credit derivatives to quickly increase our credit exposure in the strategy to benefit from the compression in credit spreads. BBB rated credit performed strongly during the quarter as there were inflows into corporate bond funds and capital was deployed in a renewed search of yield. The detractors were few and far between – with very few issuers experiencing spread widening against a backdrop where momentum decisively shifted in January.

Net Credit Leverage in the strategy currently sits at 3.4x – but owing to the short-dated nature of many of the securities in the portfolio, the strategy has a similar credit sensitivity to an unlevered 5 year corporate bond portfolio (5 year credit leverage is 1.6x). Excess Margin on the portfolio is currently above 60%. Canadian credit underperformed USD credit during the quarter, and consequently the team have taken profits in some USD positions and redeployed the capital in Canada where there now looks to be more attractive relative value. We continue to focus on BBB rated companies where we feel the risk-reward proposition is attractive – generally preferring short-dated securities in companies that we expect to de-leverage over time.

Performance Commentary – RP Select Opportunities

The RP Select Opportunities strategy posted 4.22% return in Q1 as credit spreads retraced much of the weakness of the previous quarter. As interest rates reversed course and started to fall, there was a flow of funds out of leveraged loans (which are floating rate, typically referencing LIBOR) and into fixed-coupon high yield bonds. These inflows into high yield funds led to strong price performance for bonds rated sub-investment grade.

In terms of winners, we had some notable successes in the US midstream / energy infrastructure segment with securities issued by Energy Transfer Partners and NGPL PipeCo performing well. Also on the "top performer" list were a number of regional financials and specialty finance companies (examples being CIT Group and First National Financial Corp). In general there was a "flight to quality" within high yield, with BB-rated companies leading the charge and lower rated securities just about keeping pace.

From a positioning perspective, the portfolio closed the quarter with Net Credit Leverage of 1.6x and even with this leverage the overall credit duration of the portfolio sits at 3.7 years. Around 70% of the positions in the portfolio are rated either BBB or BB, and the majority of the investments in the portfolio are denominated in USD (with the currency risk hedged back to CAD). We have an 11% allocation to loans within the strategy – in some cases we have been able to establish positions in these secured instruments at yields greater than those offered by unsecured high yield bonds that sit lower down in the issuer's capital structure. We believe that the flexibility that this strategy has to explore a wide range of credit securities positions it very well at this point in the cycle.

Performance Commentary – RP Fixed Income Plus

With the backdrop of lower yields and tighter credit spreads, the RP Fixed Income Plus strategy had a strong quarter, returning 2.33% and outperforming the FTSE Canada Short Term Bond Index by 0.59%. Relative to the FTSE Canada Short Term Bond Index, the strategy underperformed slightly on interest rates (average duration of the fund was 2.0 years. versus 2.7 years for the index) but outperformed strongly on credit spreads. A key driver was the fact that global credit performed considerably better than Canadian credit during Q1. This was the opposite of what we saw in Q4 of last year where Canadian credit acted as a "safe haven".

Given the positive tone in the market following the Fed's policy shift, almost all securities in the portfolio contributed positively – with compression in spread the principal driver of the return (although coupon income and trading were both positive for the period). Three of the top performing securities in the portfolio were senior notes issued by UK banks in U.S. dollars. Other strong contributors were Fairfax Financial, Bell Canada and Molson Coors. We saw strong performance from floating rate notes which were trading at a discount to fixed coupon bonds at the start of the year.

The strategy began the year with a yield of around 3.60%. The yield of the portfolio today is below 3% partly because yields and spreads have compressed, but also because we have sold longer-dated positions and rotated the proceeds into 2 to 3 year securities. Many of these are floating rate notes that reference 3-month LIBOR which is trading at a similar level to 10 year Treasuries. Interest rate duration of the fund currently sits just below 2 years. Currently more than half of the corporate bond positions we have in the portfolio are denominated in USD (with the currency risk hedged back to CAD).

Important Information

Unless indicated otherwise, all returns and portfolio data is presented as at March 31, 2019.

The information presented herein 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 RP Investment Advisors LP ("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 data cited is RPIA. This document 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. The investment strategies presented herein are offered in Canada as RP Fixed Income Plus Fund, RP Debt Opportunities Fund Trust, RP Select Opportunities Fund and RP Corporate Index Plus. These funds are qualified investors only, pursuant to prospectus exemptions in NI 45-106 "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. Trade examples are presented for illustrative purposes and does not necessarily reflect a trade or current holding in any particular RPIA strategy or fund.

Strategy returns are in Canadian dollars and is net of all fees and expenses. Actual returns may vary from one investor to the next in accordance with the terms of the governing documents of relevant entities. Unless specified otherwise, returns presented for periods greater than one year are annualized. Performance is not guaranteed and past performance may not be repeated. RP Debt Opportunities strategy returns are based on composite returns of RP Debt Opportunities Fund LP Class A and RP Debt Opportunities Fund Ltd. Class A, from October 2009 to July 2011 and RP Debt Opportunities Fund Ltd. Class A. from August 2011 onwards. RP Fixed Income Plus strategy returns are based on the weighted-average composite return of separately managed accounts utilizing a similar strategy from inception in July 2010 to April 2013 and linked to the returns of the RP Fixed Income Plus Fund Class A thereafter. RP Select Opportunities strategy returns are based on the weighted-average composite return of a separately managed account utilizing a similar strategy from inception in April 2014 to June 2014, and then linked to the returns of RP Select Opportunities Class A thereafter. Growth charts are used to illustrate the effects of a compound growth rate and is not intended to reflect future values of any RPIA fund or strategy.

The portfolio characteristics presented, including risk measures and holdings based data reflects that of the indicated RPIA strategy. Certain investment strategies offered by RPIA in Canada may gain indirect strategy exposure by investing in units of applicable strategy feeder funds.