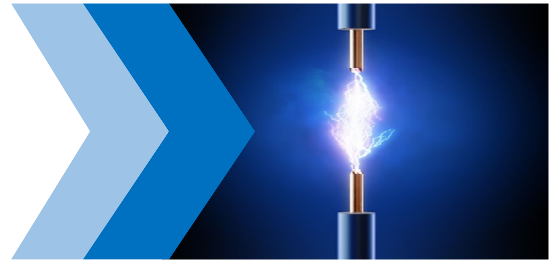
Back to the Future

May 2019 Commentary



Executive Summary

- US-China trade negotiations broke down in early May and have re-ignited market speculation that the Fed and Bank of Canada will take a much more accommodative stance versus prior periods
- This shift in sentiment has led to even more distorted yield curves in North America and more negative yielding bonds globally which reminds us of past periods where central bank policy caused unusual market dynamics
- Headwinds out of Europe continue thanks to BREXIT and Italy unknowns
- As a flexible fixed income manager, RPIA welcomes these distortions in rates as they reveal pockets of relative value within corporate bonds that we can quickly capitalize on for our investors

HOW QUICKLY THINGS CHANGE

It seems like only yesterday that every investor we spoke to was concerned about the impending end of the secular bull market in bonds, a fire that would be sparked by ever increasing interest rates. While the Fed (and Bank of Canada to a lesser extent) successfully embarked on this path to normalization by hiking rates from ultra-low levels, the journey was surprisingly short lived. Things really began to change in late 2018 with the 'Fed pivot' and now, with U.S.-China trade negotiations breaking down in early May, investors are left with serious concerns over a looming recession and the unpredictable nature of geopolitical risks. This shift in expectations has fundamentally changed the current direction of interest rates and caused markets to price in more accommodative central bank posturing from here on out. To some extent this new direction in interest rate expectations reminds us of past periods where monetary policy intervention and looming recession fears led to unusual dislocations across fixed income asset classes.

The market has made clear their expectations for the Fed to provide "insurance rate cuts" to fight the headwinds of trade tensions and slowing global economies. Markets are now expecting the Federal Reserve to cut interest rates twice in 2019, a far cry from the "auto-pilot" hikes that were the norm in mid-2018. These concerns have not only impacted future expectations for interest rates but have also revealed themselves in the form of investors reallocating to the safety of government bonds. This reallocation caused 10-year US Treasury yields to decline from 2.50% to 2.12% and Canadian 10-year yields to drop from 1.71% to 1.48%. In response, credit spreads widened modestly in May as investors demanded higher compensation for taking on corporate bond risk. This was a drag on the performance of our funds during the month.

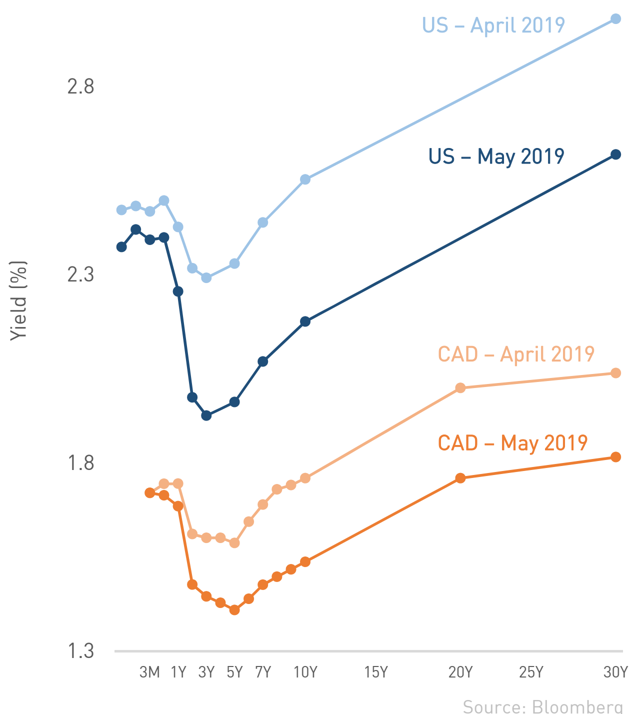
Interest rate markets repriced lower in 2019, accelerating in May

MARKET DYNAMICS ARE FURTHER DISTORTING YIELD CURVES

As the market all but considers future easing a "sure thing", we saw distortions in North American yield curves become even more pronounced, leaving us with an accentuated "check mark" shape. This shape is a result of investors who are willing to lend money to the U.S. government for ten years at a rate that is 20 basis points less than what they would receive to lend money for only three months (the yield on the U.S. ten year is 2.15% versus 2.35% on 3-month treasury bills).

This phenomenon makes little sense relative to the "normal" upward sloping curve but also speaks to how quickly the market has shifted to pricing in slower economic growth and the reemergence of accommodative central bank policy. This narrative is not contained to North America. European governments have also been relatively accommodative with serious concerns for risk of recession, to the point where we are starting to see statistics that remind us (to some extent) of prior periods of coordinated easing which pushed interest rates to extremely low levels. For example, more than 25% of all bonds outstanding currently offer investors a negative yield (see call out box below on who would buy negative yielding bonds).

North American yield curves have further distorted over the month of May.



WHAT TYPE OF INVESTOR WOULD BUY A NEGATIVE YIELDING BOND?

It is often asked why anyone would ever dream of buying a negative yielding bond. Readers may be surprised to find that there are surprisingly numerous investors that are happy to buy bonds with negative yields. This category includes investors that fear or expect deflation or investors who are confident that currency appreciation gains will outweigh the negative yield drag they experience when owning such instruments.

Central banks, such as the ECB and Bank of Japan, have had an insatiable appetite in recent years for bonds with negative yields used as part of their exceptional monetary policy tools. Their buying also brings about opportunistic investors in search of capital gains who have, from time to time, tried to generate these gains by buying these same negative yielding bonds ahead of the central banks. Even commercial banks can be motivated to buy negatively yielding instruments – especially if they operate in jurisdictions where there are negative deposit rates (such as in Europe).

THESE DISTORTIONS ARE OFFERING RELATIVE VALUE OPPORTUNITIES

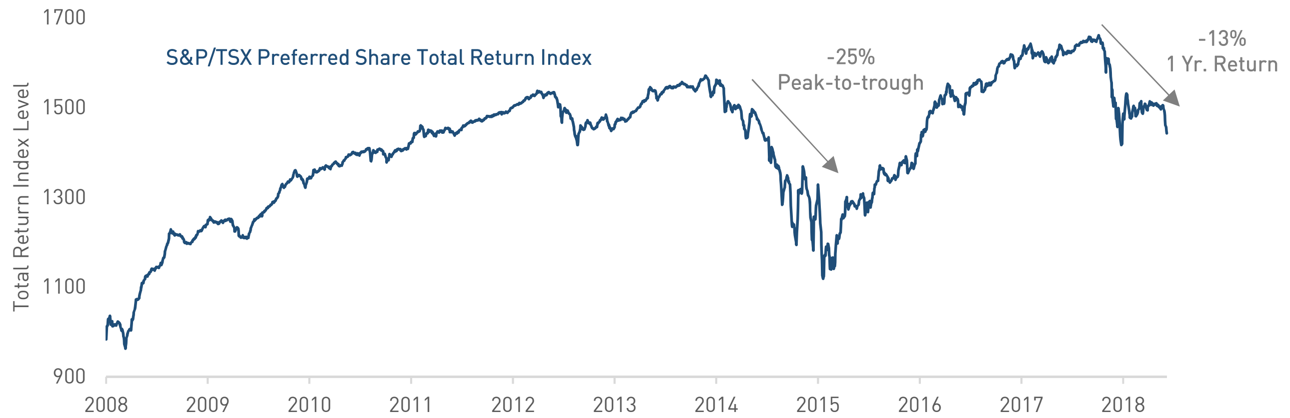
With this change in expectations for central bank accommodation and global slowing, we are starting to see distortions in the market which, for a flexible manager such as RPIA, offer interesting opportunities to extract value for our clients. One example is opportunities emerging in U.S. corporate bonds. As yields fall, bond prices increase, leading to some profit-taking from the investors that want to realize gains. In selling these bonds to lock in their profit, credit spreads tend to widen as the new buyers need to be enticed into the market with additional yield. Given our flexible mandate, we are more than happy to act as a liquidity provider when that additional spread accurately compensates us.

To this end, some of the largest moves in credit spreads during the month of May were in BBB and BB rated corporate bonds, driven largely by interest rate movements and less as a reflection on the fundamental quality of the issuers. An example would be the shorter-term bonds of the specialty finance company CIT Group. Without any real change in fundamentals, the credit spread on these securities have moved wider during the month of May. We think this new higher spread offers a relatively attractive level to add to our existing positions. Other examples include spread widening seen in Diamondback Energy (a hydrocarbon exploration company) and CyrusOne (a REIT) due to the same underlying change in interest rates. We have taken the opportunity to add to these and like positions.

RATES MARKET IMPACTING PREFERRED SHARES

Another knock-on effect from the change in interest rate outlook has surfaced in the Canadian preferred share market which has performed very poorly as of late. The Canadian preferred share market is a unique beast. Because preferred shares pay dividends rather than a coupon (which is treated as income) they often form a constant allocation in the portfolios of retail investors. However, these instruments are highly sensitive to moves in interest rates. Specifically, when forward expectations for interest rates decline, the instruments tend to fall in value as expected future coupons are lower.[1] During the few years where the Fed and Bank of Canada's interest rate hikes were set on "auto-pilot", this benefited certain structures whose dividend would reset to higher levels offering progressively more attractive income to investors. However, as expectations made such a sharp U-turn in May, the preferred share market posted a 12-month total return of -13%.

Canadian preferred share markets have experienced significant periods of negative performance and high volatility



Source: Bloomberg

Thanks to this most recent period of performance, preferred shares have offered investors a near zero return over the past five years and with plenty of volatility along the way. This is the risk-reward profile we generally try to avoid and believe this fact should bring into question whether preferred shares are better treated as a tactical allocation within investors' portfolios rather than a strategic one.

Once again, however, where we see large disruptions is also where we begin to see value. In this case recently issued Canadian preferred shares with high back-end reset spreads were issued at attractive levels which we think compensate our investors appropriately for the underlying risks. These instruments are less sensitive to changes in interest rate expectations as they have a larger credit spread "cushion", insulating them (to a degree) from future interest rate drops. The recent repricing has been dramatic, with new issues offering yields close to 2015-2016 levels even though today's interest rates are close to 100 basis points higher versus that prior period in 2015/16. Therefore, we have selectively added some of these positions to our mandates where appropriate.

We hope you have found this monthly letter to be informative. Please direct any questions or comments to investors@rpia.ca

[1]This dynamic is most applicable to 5 year rate-reset structures, which have become the most common structure issued in the Canadian market. Other types of instruments behave differently with changes in interest rates.

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