Credit Market Themes in 5 Charts

Q4 2022

A New Chapter for Fixed Income

2022 was a challenging year for nearly all publicly traded asset classes, as central banks increased interest rates aggressively to tame inflation in a complex macro environment. Broadly speaking, traditional government and corporate bond strategies provided little protection and most investors experienced negative returns from their fixed income and equity allocation simultaneously. RPIA's alternative fixed income strategies were able to avoid significant drawdowns experienced in traditional strategies and add significant value for our investors.

As we approach the end of the rate hiking cycle, we strongly believe that now is the time for allocators to be adding to high-quality fixed income. On an absolute basis, bond yields are greater than they have been in many years, which means investors get paid to wait with a wide margin of safety if rates were to continue to rise. On a relative basis, the risk-reward of fixed income appears superior to both equity investments and traditional alternative assets such as real estate and private assets.

BBB-rated bonds are now offering the same yield as real estate cap rates (which have historically offered a premium) without sacrificing liquidity. The return available from publicly traded investment grade credit also compares very favorably to historic returns from lower quality private debt portfolios. Investors can benefit from the transparency of knowing that bonds have repriced to fair value ("mark to market") compared to a more opaque private debt portfolio. The relationships exhibited between dividend yields, cap rates, and fixed income yields all suggest an attractive proposition for investors to increase fixed income allocations.

Looking forward, we think that the markets will remain volatile in 2023 as central banks continue to tighten financial conditions and the implications for asset valuations and the real economy remain uncertain. Although we are in the early stages of a recession, corporate credit fundamentals in many areas remain sound as issuers took advantage of the low funding costs in 2020 to refinance existing debt, making them well-prepared for an economic slowdown. At this juncture, we believe that active management is crucial for navigating the market as the year unfolds to create diversified returns for investors while also prudently managing risk.

On the following pages are 5 charts that sum up our takeaways from 2022, as well as our outlook for 2023. We hope you will find them thought-provoking.

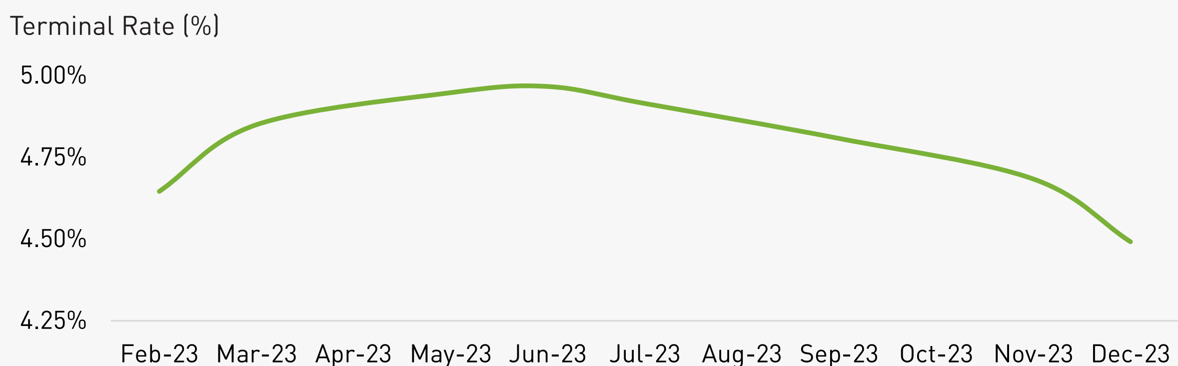
Please feel free to contact us if you would like to discuss further or learn how we can help you meet your investment objectives.

1 Light at the End of the Tunnel

Historically, investing in advance of the final rate hike has generated strong returns

Sharply rising interest rates in 2022 meant the worst return for bonds in a century; however, we believe there is an opportunity going forward. Market pricing implies we will reach the peak overnight rate this cycle in mid-2023. Historically, investing in the bond market approaching this final interest rate hike has been a profitable strategy for investors.

Markets Imply US Interest Rates Will Peak at Around 5% in Mid-2023



Investing Near the End of a Rate Hike Cycle Produces Strong Returns

Rate Hike	First 12 months return (based on dollar cost average)	Annualized total return over five years
Jun 2006	4.5%	5.9%
May 2000	5.3%	7.2%
Feb 1995	7.7%	6.8%
Feb 1989	10.2%	10.6%
Sept 1987	7.0%	9.6%
May 1981	3.3%	15.6%

Data as of Jan. 6th, 2023. Source: Bloomberg. Index = Bloomberg U.S. Aggregate Bond Index.

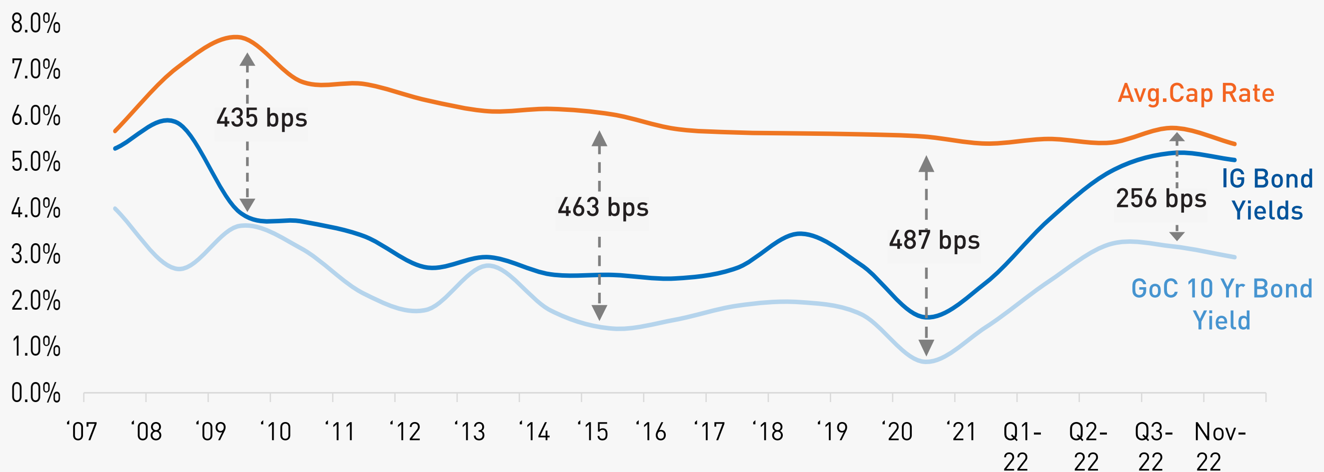
2 Balancing Yield and Liquidity

Bonds can provide a yield competitive with real estate cap rates for the first time since the Global Financial Crisis

Over the last decade, investors moved away from traditional fixed income as part of the search for yield. A popular substitute for fixed income was real estate, with cap rates 2-3% higher than the yield offered by BBB-rated corporate bonds. With the interest rate increases of the last 12 months, we believe investors can now capture a yield on bonds that is basically the same as the cap rate on a real estate investment, but without sacrificing liquidity.

Bond Yields Rose Sharply This Quarter, Closing the Gap to the National All-Asset Cap Rate

Yield Level



Data as of Nov. 30th, 2022. Source: Colliers Cap Rate Report, Q3 2022, Bank of Canada and Big 6 Banks

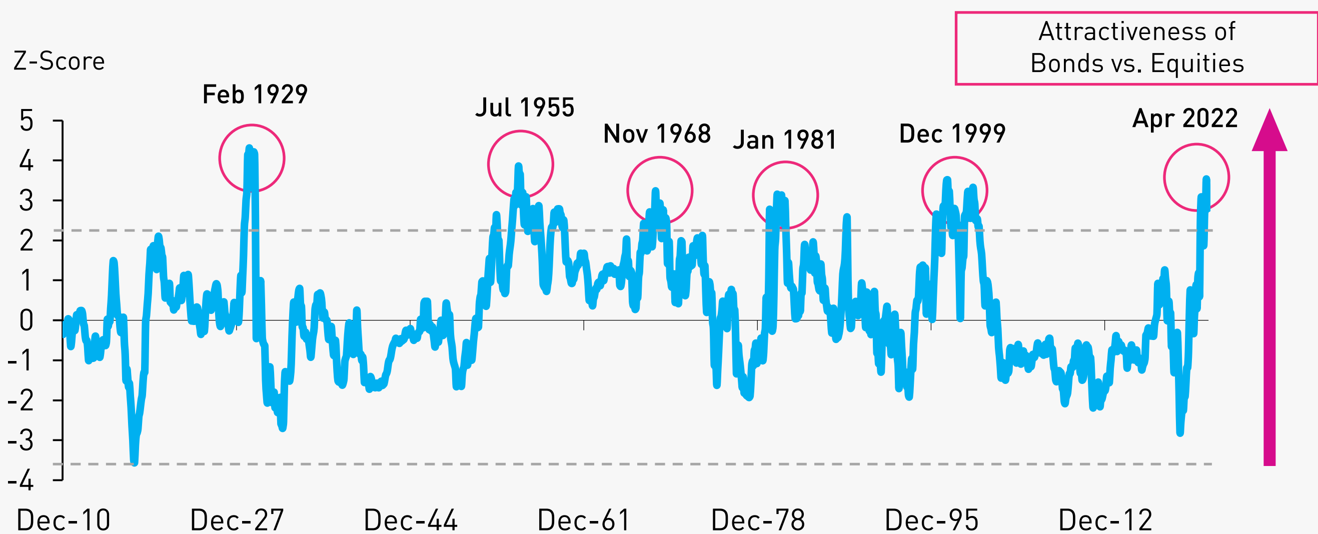
3

Credit vs. Equities

Bonds are the cheapest they have been to equities in 20+ years

The historical relationship between bond yields and the earnings yield of equities is 2-3 standard deviations away from the average. That is to say, from an income perspective, bonds are positioned much more favorably than equities. This disconnect has been driven by the dramatic increase in short-term interest rates, which means bond yields fall in the short-term, but could set the stage for higher returns in the long-term.

US Bond/Equity Yield Ratio (10 Yr Z-Score)



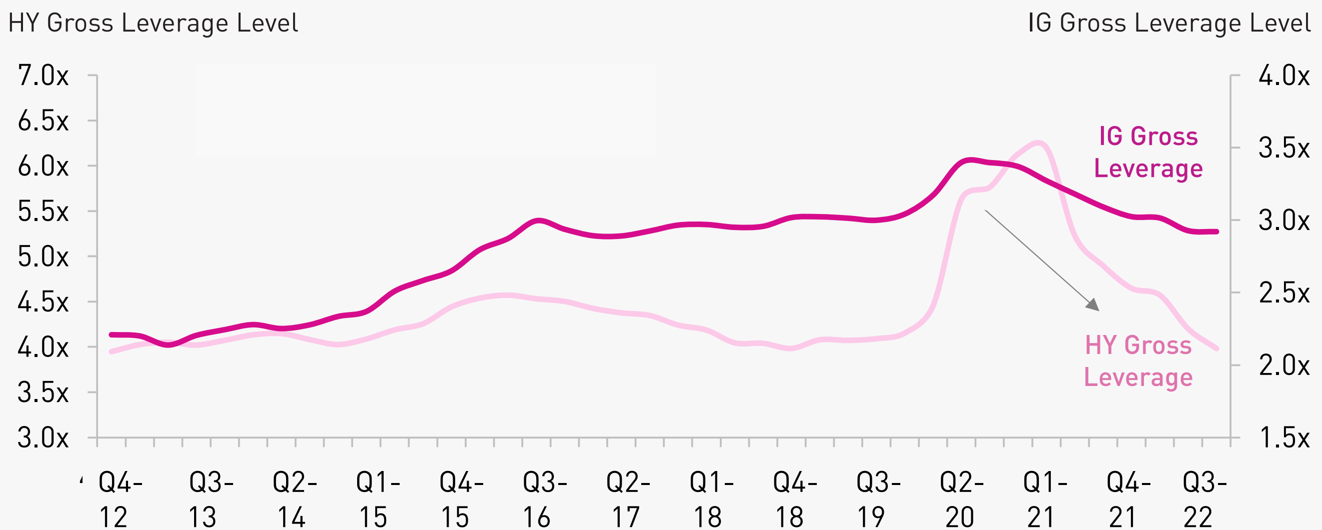
Date as of Dec. 30th, 2022.
Source: Absolute Strategy Research. US Bond Yield: Yield to maturity of 10-Year US government bond;
Equity Yield = Dividend yield of S&P 500. Z-Score is calculated as the observed value at any certain time point minus average of the dataset, divided by the dataset's 10-year standard deviation.

4 Issuers Prepare for a Slowdown

Corporate borrowers have reduced leverage, meaning they are better positioned for a slowdown

Since the COVID-induced market crisis of 2020, corporate treasurers at both Investment Grade (IG) and High Yield (HY) rated companies have reduced leverage. In addition, many companies took advantage of low funding costs to extend maturities and refinance upcoming debt issues early. As such, corporations, particularly IG-rated ones, are heading into a period of slowdown well-positioned to weather the storm.

IG and HY Companies Have Reduced Leverage in Recent Quarters - Meaning They Are Better Positioned As We Enter an Economic Slowdown



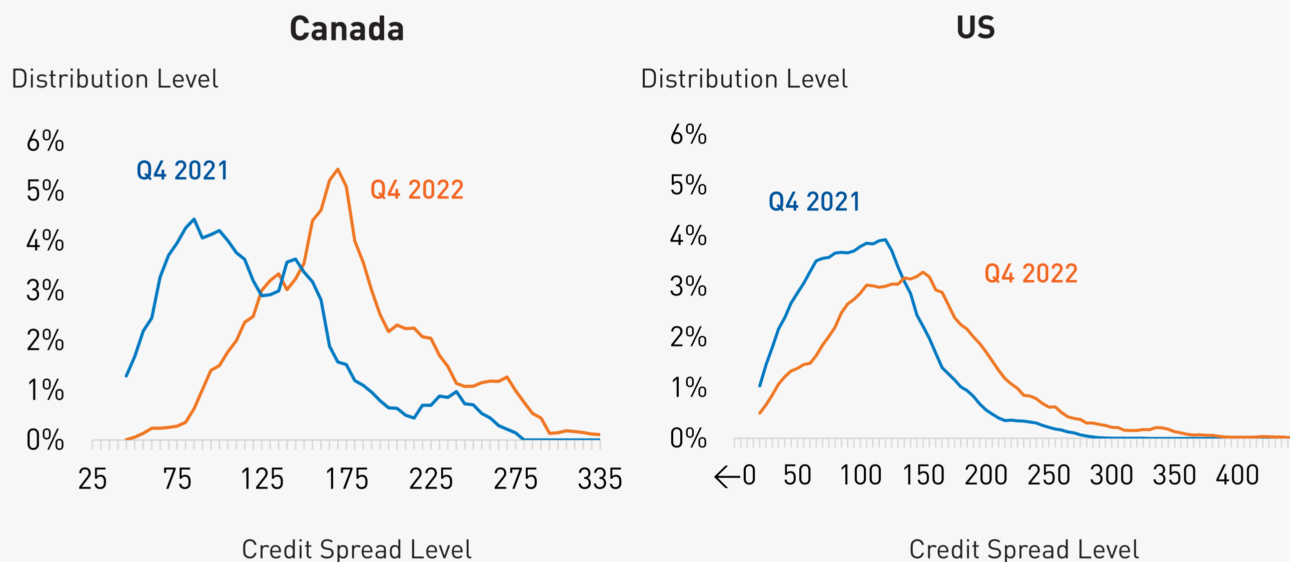
Data as of Sept. 30th, 2022.
Index = JP Morgan Global Credit Research Universe. Source: JP Morgan, CapitalIQ.

5 Better Opportunities

More dispersion in credit spreads means more opportunity from active management in Canada and the US

Given the mounting evidence of economic recession in the past year, credit spreads have widened across various markets and sectors. In addition, the spread differentials between issuers within the same sectors have also increased significantly. This wider range of valuations across the board can indicate more opportunities for an active manager to find relative value in corporate bonds through the security selection process.

There Is a Much Wider Range of Valuations in IG Credit Today Versus a Year Ago



Data as of Dec. 31st, 2022.
Source: Bloomberg. CA = Bloomberg Canada Corporate Total Return Index; US = Bloomberg US Corporate Total Return Index Unhedged USD

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The index performance comparisons presented are intended to illustrate the historical performance of the indicated strategies compared with that of the specified market index over the indicated period. The comparison is for illustrative purposes only and does not imply future performance. There are various differences between an index and an investment strategy or fund that could affect the performance and risk characteristics of each. Market indices are not directly investable and index performance does not account for fees, expense and taxes that might be applicable to an investment strategy or fund. "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.

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