RPIA
Global Fixed Income Experts

Seeking Opportunity in Rising Yields

Since the beginning of 2021, bond holdings have posted double-digit losses and weighed down portfolio performance.[1] However, as it is often the case in markets, with pain comes opportunity. Despite the potential for continued short-term volatility, we believe the time to increase bond allocations for intermediate and long-term investors is now.

Anticipated Rate Increases are Largely Priced into Higher Yields

Suggesting that fixed income looks attractive is wildly unpopular today, but it should be recognized that the market has already priced in an additional 2.25% increase in rates from the US Federal Reserve, even after their most recent 50bps hike last week – that is equivalent to 9 quarter-point hikes from now until May 2023.[2] Under this assumption, the “terminal rate” (the rate at which markets believe the Federal Funds Rate will peak in this hiking cycle) will approach 3.25% in the US.

It is a similar story in Canada. The overnight rate sits at 1.0% after the latest 50bps rate hike in April, while the yield on the 2-year government bond sits at approximately 2.7%.[3] This means that an investor can effectively buy bonds and “lock in” a good amount of the anticipated increases in rates today, even though they may not fully come to fruition.

In fact, the market’s ongoing attempt to gauge the future path of interest rates has been “feast or famine.” We went from a limited number of quarter-point hikes expected at the turn of the year to perhaps the most aggressive rate-hiking cycle in recent history. While the true path will be data-dependent, it may be reasonable to assume that the potential upper range of hikes is priced in. More importantly, the concept of margin of safety is reinstated at these yield levels, meaning the greater income stream being offered can provide a cushion to total returns even if the adverse dynamics of the current bond environment were to persist.

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[1] As of May 6th, 2022, the Bloomberg Barclays Global Aggregate Bond Index has suffered a drawdown of -16.7% since January 2021.

[2] Source: CME FedWatch Tool, CME Group Inc. (www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html). Data retrieved May 6th, 2022.

[3] Source: Bank of Canada. Data retrieved May 6th, 2022.

Anticipated Quantitative Tightening has Contributed to Higher Yields

The Federal Reserve's asset holdings are primarily made up of Treasuries and mortgage bonds backed by government agencies. These assets were more than doubled during the pandemic from $4.2 trillion to $8.9 trillion until March 2022, when the Fed officially stopped adding to its balance sheet.[4]

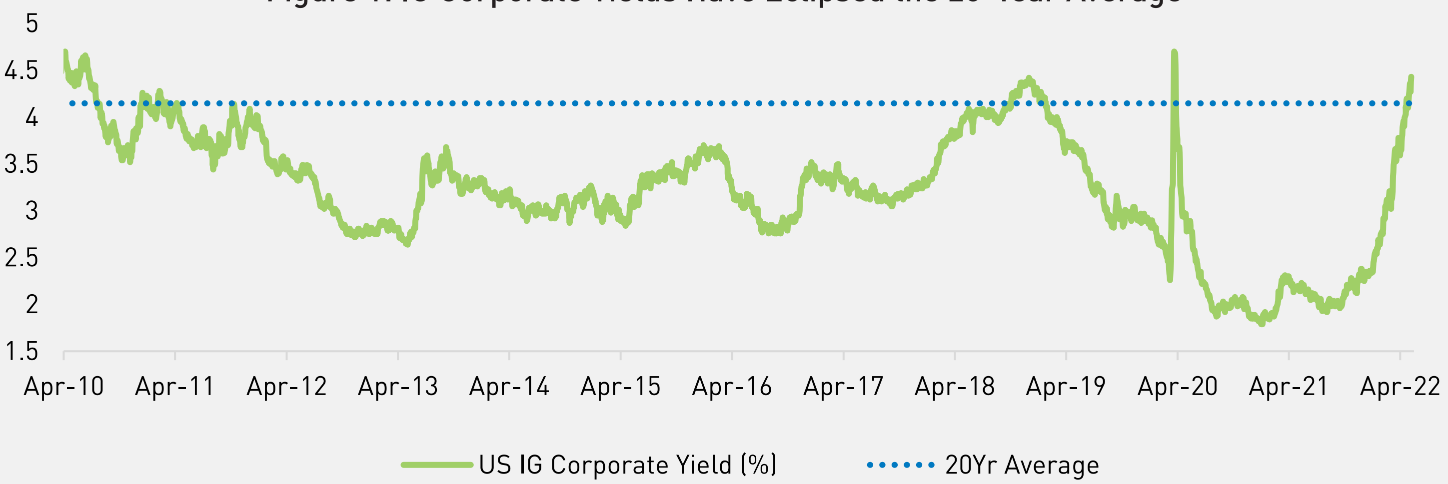
Just as Quantitative Easing drove interest rates down, Quantitative Tightening can be expected to put pressure on them to rise. The expectation for an increasing trajectory of interest-rate hikes alongside a contracting Fed balance sheet has been the key reason treasury yields soared in the first quarter of 2022.

If markets have underappreciated the potential impact of quantitative tightening, it could be the driver of more short-term volatility in bond markets. But again, given the anticipated terminal rate, we think there is enough cushion for investors to begin picking up bonds now, with a chance for capital gains if these measures turn out less aggressive than anticipated in the next 12 months.

Corporate Bonds Trading at Attractive Levels

In addition to higher risk-free rates, investors can further increase their yield pickup by taking a modest amount of credit exposure. The investment grade bond market offers a nearly 4.4% all-in yield today, a level that has eclipsed the 20-year average yield and is approaching pandemic levels.

Figure 1: IG Corporate Yields Have Eclipsed the 20-Year Average



Source: ICE BofAML, US IG Corproate YIeld = ICE BofAML US Corporate Bond Index Effective Yield.
Data as of May 6th, 2022.

[4] Source: Federal Reserve. Data as of May 4th, 2022. US Total Assets Held By All Federal Reserve Banks.

But this doesn't mean that investors should blindly lock in the highest yield possible – as many of the highest yielding bonds can also come with uncompensated interest rate risk and/or credit risk.

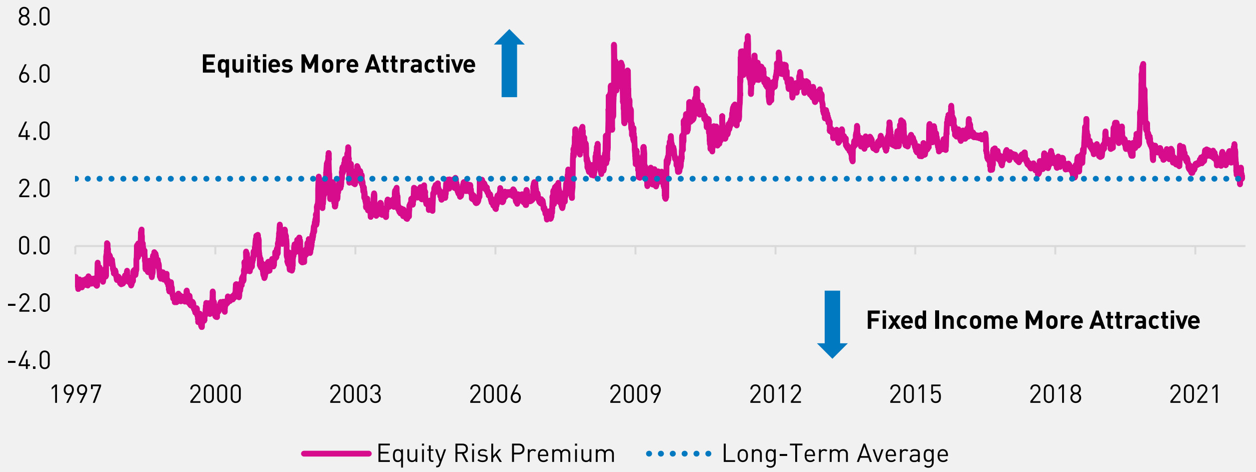
Against this backdrop of wider spreads and the sharp sell-off in rates, the level of yield support has notably improved across a variety of fixed income markets. We believe yields at these levels can provide critical upside if the Fed decides to re-evaluate and slow down over the next 12-months or inflation begins to crest and surprise us on the way down.

Buy the Dip Mentality for Bonds

Investors hold bonds because no other asset class has consistently done what they historically have – preserve capital if held to maturity (defaults are very rare for investment grade bonds) and generate modest returns.

The proverbial "buy the dip" methodology has worked wonders for equity investors over the past decade. We think investors can use a similar strategy with bonds at these levels to help insulate their portfolios prudently and keep them aligned with their risk profiles better than other income-oriented asset classes.[5] As an aside, bonds are also beginning to look attractive relative to beloved equities.

Figure 2: Fixed Income is Beginning to Look Attractive Relative to Equities



Source: Bloomberg.
Data as of May 6th, 2022.
Equity Risk Premium (EPR) = S&P 500 Earnings Yield Forward Estimate minus 10Yr US Treasury Yield, or the additional yield provided by the earning of the S&P 500 in comparison to the 10Yr US Treasury bond.

[5] For example, cash might protect your capital, but you'll lose purchasing power over time, thanks to inflation. Treasury Inflation-Protected Securities (TIPS) and floating-rate loans can have negative yields if deflation comes to pass over the coming year. Granted, commodities, cryptocurrency, and gold can diversify your equity holdings. Still, all of these bring new risks to the table and do not come with any guarantees or maturities backed by a business or its cash flows.

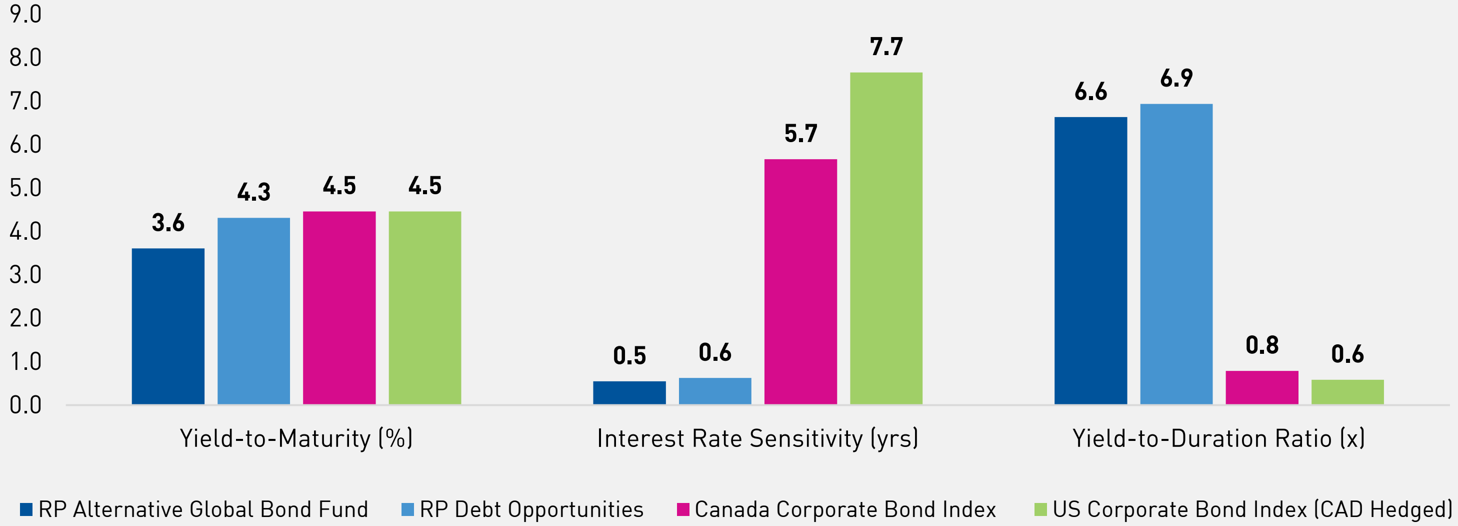
Active Management: Building a Base of Attractive Bonds

We believe you need to pick away in stages to take advantage of the opportunity right now. We recognize that each new data point and headline could spawn further volatility, but we are advocating for a gradual re-entry without trying to pick the proverbial "bottom of the market".

For example, we want to buy bonds today that will give us a predictable downside scenario over the next 2-3 years, but that has upside capital gains optionality if spreads tighten from here due to an improving economy or avoiding a recession, idiosyncratic fundamental improvements, and/or other technical market catalysts that offer relative value.

To illustrate, the table below shows how our strategies are taking advantage of yield opportunities in the market without taking on nearly as much interest rate risk as Canadian and US Corporate Bond indices.

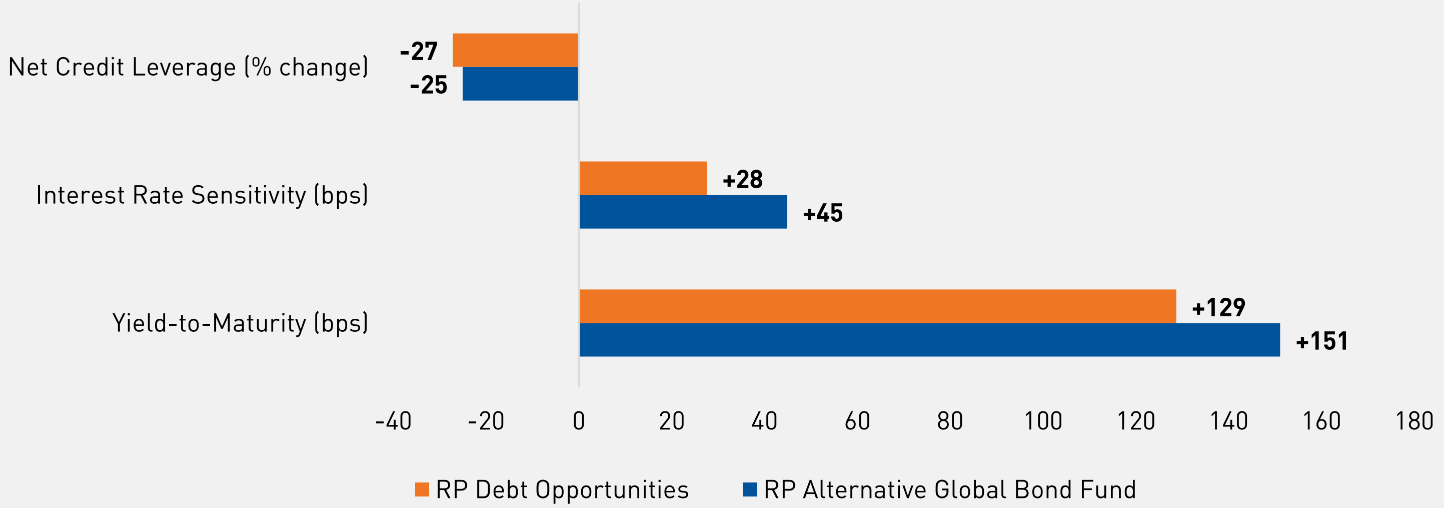
Figure 3: RPIA Strategies Can Provide Reasonable Yield Without Taking on Undue Interest Rate Risk



Source: Bloomberg Barclays, RPIA.
Data as of May 6th, 2022.

Year-to-date, the market volatility has allowed us to increase all-in yields while limiting interest rate exposure and reducing credit risk metrics. For example, RP Alternative Global Bond Fund's yield has increased +151bps while its rate sensitivity has only increased +45bps, all while its credit leverage has been reduced by -25%. This helps highlight how we pursue attractive risk-adjusted yields and not focus solely on absolute yields, which can come with uncompensated amounts of risk.

Figure 4: YTD Change in Yield, Interest Rate Sensitivity, and Leverage



Source: RPIA.
Data as of May 6th, 2022.

This is an exciting time for us as bond investors. The coming months should give us the opportunity to turn the page from solely a capital preservation focus to a more balanced stance as we search for compelling return opportunities for our investors.

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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.