

May The Fed Be With You

January 2019 Commentary



If you want to put blame or credit, the main person who influences the business cycle is the head of the Federal Reserve Bank.

-Robert Fogel, American Economic Historian

Executive Summary

- Global credit markets rallied sharply in January as the Fed offered a dovish pivot, blunting its hawkish tone in 2018 – a tone that spurred a persistent repricing of credit risk throughout much of last year.
- Improving expectations with respect to Brexit, China/U.S. trade negotiations and improving market technicals added to the constructive backdrop.
- Although we are in the later stages of the current credit cycle, we can't know when it ends. Having said that, as long as the Fed remains a tailwind, risk assets will have room to perform and the cycle can play into extra innings.
- Whatever the case, 2018's re-pricing has improved the risk/reward proposition for credit in the coming year.

THE FED'S DOVISH PIVOT COULD PERSIST AS A TAILWIND FOR CREDIT

The U.S. Federal Reserve's dovish pivot helped spark a meaningful credit rally in January. In October, Chair Powell provided hawkish commentary suggesting the Fed had scope to push short term rates above the Fed's long term neutral target - given the strength of the U.S. economy. These comments helped spark the more aggressive risk off tone seen in Q4/18. In late December, however, the Fed began to turn more cautious setting the stage for a decisively dovish pivot in January. It would seem that the Fed is now on hold for the foreseeable future and is expected to retain a flexible approach with respect to any balance sheet unwind. This about face produced a very constructive backdrop for credit in the month of January. Progress on China/US trade negotiations, and better than expected earnings in Q4/18, added to the constructive outlook. On the back of these developments synthetic 5-year investment grade (IG) and high yield (HY) spreads compressed 30 basis points (bps) and 138 bps respectively. These levels represent a reasonable proxy of the movements seen in the U.S. cash bond market (See Figure 1)

Figure 1: Credit spreads compressed meaningfully in January. Synthetic (CDS) 5-Year investment grade (IG) spreads tightened 30 basis points while high yield spreads (HY) tightened 138 basis points in the month.

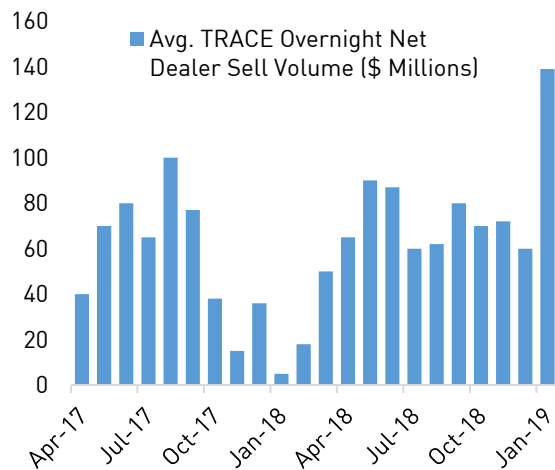


Source: Bloomberg

Foreign buyers are back in the USD market as a result of cheaper hedging costs and a more stable rates outlook. One of the most important themes for the U.S. bond market over the past several years has been the impact of foreign buyers. Up until 2018, foreign investors could invest in currency hedged U.S. investment grade bonds and capture incremental yield for like risk, relative to their home market. In the past, this incremental capture could be as much as 100-150 basis points. As U.S. rates continued to rise, and currency hedging costs rose alongside them, this economic value was eroded - leading to a meaningful pullback of foreign buying in 2018.

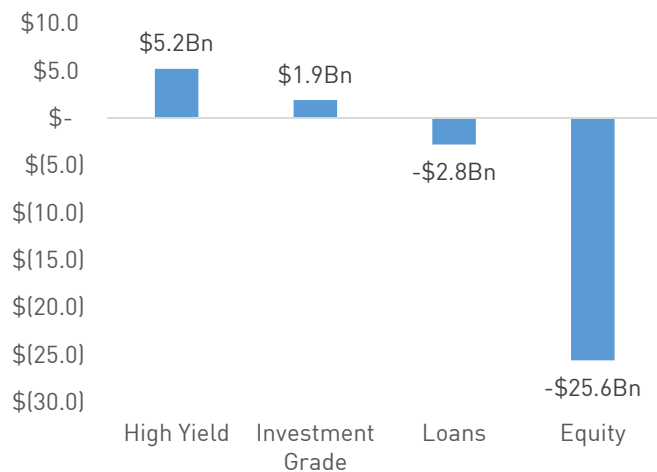
The withdrawal of this marginal buyer fed into the weak investment grade credit tone experienced in 2018. Interestingly, the high yield market was not materially impacted by this development as it remains less vulnerable to global flows. Expectations for lower rates, and a somewhat weaker currency, have spurred foreign buyers back into the USD market, as very active January overnight TRACE volumes demonstrate. These flows are often tracked as a proxy of foreign buying. In fact, January saw some of the highest levels of activity in several years. Assuming the Fed retains its benign rates outlook, these buying patterns could persist. (See Figure 2).

Figure 2: Foreign buyers came back to the U.S. Market in January.



Source: Bloomberg; Citibank

Figure 3: Investment grade and high yield credit saw meaningful fund flows in the month.



Source: Bloomberg; Citibank

Lower rate expectations sparked a rotation back to fixed income. Looking at fund flows in the month of January, we saw a meaningful uptick in fixed income flows with roughly \$1.9 billion rotating into investment grade funds/ETFs and \$5.2 billion into high yield. In contrast, equities and leveraged loans saw outflows of ~\$25.6 billion and -\$2.8 billion respectively (See Figure 3). At the same time, rates volatility has receded which we'd expect to be generally supportive of credit performance. This was reflected in the U.S. new issue market where January performance was strong. On average, new issue releases tightened ~9.4 basis points in the month.

FED SENTIMENT WILL DRIVE THE COURSE BUT BE PREPARED FOR SHIFTING CONVICTIONS

We can't know when late cycle turns into end cycle but credit assets could play extra innings here. In 2018 investors weren't fully rewarded for good fundamental credit work because the market was in the midst of a fundamental re-pricing driven by the Fed's desire to reduce forward guidance, re-introduce volatility and continue to unwind extraordinary levels of monetary policy stimulus.

We can know some things and not others. For example, we can know that the re-pricing of credit assets in 2018 has provided a much better risk reward opportunity for our portfolios. We can also observe that the Fed's recent shift in sentiment has altered investor behaviors in ways that could persist. These observable phenomena give us some confidence that credit can potentially continue to perform here for some time.

We can also know that, as Mason Cooley once said, *the passion for money is never fickle* – and whether it be shifting Fed sentiment or the market's collective propensity for greed or fear – we can observe that late cycle dynamics are making this passion quicker to inflame. Despite the value opportunities we see at hand, we have increasingly positioned our portfolios to be nimble and to be able to preserve capital or extract value as circumstances warrant.

We can't know precisely when the end of the current credit cycle will come but we can observe value, we can observe and manage for the irrationality of behavior – and we can know not to fight the Fed.

With that said, May the Fed be with you...

...Always.

CORE BOND REPLACEMENTS

Performance Commentary – RP Strategic Income Plus Fund (“STIP”)

Credit markets rebounded meaningfully in January as dovish commentary from the U.S. Federal Reserve, progress on China/U.S. trade negotiations and a better than expected earnings season were supportive of credit globally.

Improving sentiment with respect to “Brexit” developments in the UK bolstered our core conviction investments in UK banks as expectations for a disorderly “no-deal” outcome receded materially.

Holdings such as Santander UK (ring fenced UK bank) and Royal Bank of Scotland were clear beneficiaries of the improved European tone. Relative to global comparables, we believe we are well compensated for the relative risk we assume in these names. We continue to view British banks as being very well capitalized with oversight from a very strong regulator. We take added comfort from the BoE’s 2018 stress tests which assumed more severe conditions than existed during the global financial crisis. The UK’s seven largest lenders all passed, showing they could continue lending even in the context of a no-deal Brexit. The analysis assumed an 8% drop in economic output within a year, a 25% drop in the pound and a 30% plunge in house prices.

Dragging on performance in the month was Bacardi Ltd. We continue to view Bacardi as a core conviction holding as we remain confident in the company’s commitment to broadly achieving investment grade ratings. The company has a strong record of doing so in the case of previous acquisitions. Bacardi’s 2018 acquisition of Patron, with its high growth potential, improves the company’s product diversity and presence in the premium brand business, which should drive higher profit margins. Negative sentiment on the name is partly tied to generally negative industry sentiment, but Bacardi’s strategy to focus on premium brands will continue to differentiate them and drive positive performance, in our view.

Given that we appear to be in the later stages of the current credit cycle, we have retained an interest rate duration (sensitivity) of about 4-years. We believe this positioning leaves us well placed to adjust and preserve capital should we see a material slowing in growth, or an uptick in inflationary pressures.

On the back of the global credit repricing seen in 2018, the fund has been able to position more conservatively while capturing a higher running yield. Despite the recent rally, we continue to see interesting global value opportunities. As well, we believe market supply dynamics continue to bode well for credit performance in the near term.

Performance Commentary – RP Fixed Income Plus (“FIP”)

Overall, the strategy takes a barbell approach to risk investing in high quality paper that enhances portfolio stability while employing fundamental research to exploit value opportunities in investment grade credit globally.

Towards the end of 2018 higher short term rates and wider credit spreads made for a better risk/reward opportunity in shorter dated securities. As well, January’s strong credit tone provided an excellent chance to reduce term risk. To take advantage of these developments, and to further anchor the strategy’s price stability, we increased the portfolio’s exposure to government and near cash investments. In the process, we monetized longer dated positions that had performed well, including names such as Fairfax Financial, some UK bank positions and market beta proxies such as BCE.

Value opportunities in floating rate notes prompted us to rotate more heavily into these types of securities, which reduced our interest rate risk and allowed us to capture value as these securities typically traded at much more attractive levels than comparable fixed coupon corporate bonds.

Dragging on performance modestly in the month were higher quality government exposures, which underperformed given the strong risk tone. As well, Enbridge Hybrid securities underperformed as the general backdrop for oil/energy improved but remained underwhelming.

We continue to see interesting value opportunities in the global marketplace while the strategy’s running yield is significantly more attractive in the context of its very defensive positioning. From our perspective, the strategy’s risk/reward opportunity is significantly more compelling than was the case in 2018.

LONG/SHORT CREDIT STRATEGIES

Performance Commentary – RP Debt Opportunities (“DOF”)

Credit markets rebounded meaningfully in January as dovish commentary from the U.S. Federal Reserve, progress on China/U.S. trade negotiations and a better than expected earnings season were supportive of credit globally.

Improving sentiment with respect to “Brexit” developments in the UK bolstered our core conviction investments in UK banks as expectations for a disorderly “no-deal” outcome receded materially.

January also saw a material return of overseas investment grade bond buyers back into the U.S. dollar market. Better yield opportunities in the USD market and more stable currency hedging costs spurred the demand.

The broad based rally in investment grade credit warranted getting long 5-year investment grade index risk – which proved to be the most profitable strategy trade in January. Senior financial paper (e.g. Goldman Sachs and Citibank floating rate notes) also performed very well. In contrast to senior paper, financial sub-debt dragged on performance.

As January came to a close, we took down risk into market strength. Despite January’s very strong rally in credit, we continue to see interesting pockets of opportunity on the back of 2018’s repricing of rates and risk. We believe the opportunity set for credit remains much more compelling than it has been in some time.

Performance Commentary – RP Select Opportunities (“SOF”)

January saw the return of overseas investment grade bond buyers back into the U.S. dollar market. Better yield opportunities and more stable (lower) currency hedging costs helped to drive very strong foreign demand to start out the year.

Some of the best performing names in January included Athabasca Oil, which closed its previously announced Leismer Infrastructure transaction with Enbridge Inc. for C\$265 million in cash. The proceeds significantly bolster the company’s liquidity profile, reduce net debt and improve financial resiliency.

CIT Group Inc. which we continue to view as a core conviction holding and upgrade story also performed well in January. The company has worked strategically to transform itself from a specialty finance firm into a regional bank after selling aircraft leasing interests, its European rail leasing business, and re-focusing its activities in the U.S. market. CIT is well capitalized with a tangible common equity ratio of 12.2%. Further operating refinements are expected to strengthen its resilience to downside stresses. These initiatives include actions to further strengthen the bank’s deposit mix, reduce operating costs, and remix commercial and industrial lending. As well, we see upside potential in the name as it could become an acquisition target for a large regional or large cap bank.

The combination of the Fed’s dovish commentary sending rates lower, and credit curve steeping to start out the year, translated into some substantial performance for short dated assets. Our position in Rockies Express Pipelines (1.5 year maturity) tightened ~100 basis in January.

Although SOF’s positioning is generally more conservative than was the case last year, we have been able to take advantage of 2018’s risk asset repricing. At the beginning of January, SOF’s gross running yield was ~7.5% while employing leverage of only 1.35x.

Despite January’s very strong rally in credit, we continue to see interesting pockets of opportunity on the back of 2018’s repricing of rates and risk. We believe the opportunity set for credit remains better than it has been for quite some time.

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