Near-Term Confidence, Long-Term Concerns

October 2019 Commentary

Executive Summary

- October saw risk assets rally as near-term uncertainties became less uncertain
- For the latter half of 2019 manufacturing has been in contraction while consumer health has been strong – this reversed in October
- The dichotomy between near-term confidence and long-term concerns has created interesting dislocations in credit markets that we can take advantage of

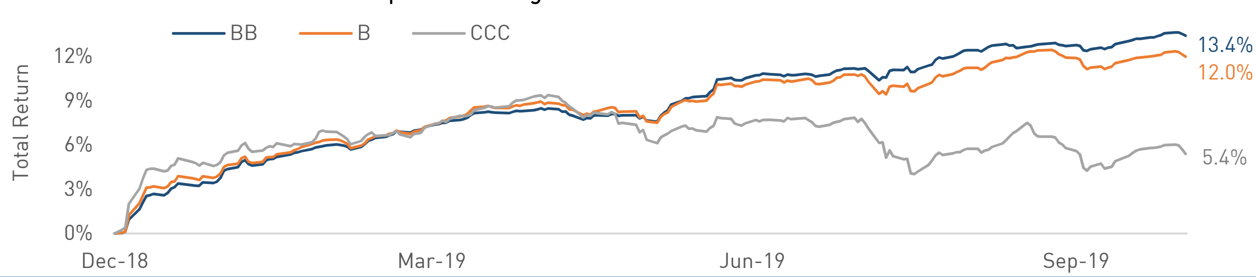
NEAR TERM UNCERTAINTIES BECOMING LESS UNCERTAIN

Investor sentiment turned decidedly "risk-on" in October, mainly driven by progress in U.S.-China trade relations. This alone was enough to push the S&P 500 to new all-time highs. Strength in cyclicals, value and small-cap stocks all suggested that investors were more than happy to take on risk during the month. The same sentiment could be found in fixed income markets with interest rates rising through most of the month and credit spreads tightening across major geographies. Macroeconomic data was relatively mixed with the manufacturing sector showing a slight rebound from previous periods. While this change was constructive, we are cautious to call the bottom of the manufacturing slowdown. The U.S. consumer, who has been carrying the economy for most of the year, began to show some weakness with retail and motor vehicle sales slowing. However, payrolls and average hourly earnings continue to post strong numbers. Overall, while economic data may be starting to stabilize, we are conscious of the large tail risks which are still prominent in the market (U.S.-China relations, impeachment, BREXIT, etc.) and we would argue that the market is responding to near term uncertainties becoming less uncertain rather than a meaningful change of view on the longer-term concerns for a slowing global economy and recession risk. This juxtaposition between near-term confidence and longer-term caution is causing dislocations in certain parts of the credit markets within which we have found relative value opportunities – both to add some defensive positions and to exploit pricing dislocations.

CREDIT REFLECTING WILLINGNESS TO TAKE ON RISK…UP TO A POINT

The dichotomy between near term confidence and longer-term concerns is reflected within the relative pricing of both investment grade and high yield markets. Investors have been more than willing to stretch for yield by buying BB and B rated bonds, pushing spreads to tighter levels. However conviction has not been strong enough to push investors into riskier parts of the credit spectrum. This has led to underperformance of the CCC section of the market. CCC rated bonds have only returned 5.4% year-to-date versus the total return of 13.4% from BB rated bonds and 12.0% in B rated bonds[1] - an unusual dynamic where investors are paid to take less risk. This phenomenon suggests that investor confidence has its limits at this point in the cycle.

CCC Section of the Market Has Underperformed Higher Rated Sections



Source: Bloomberg
Please see disclaimer for index definitions

[1] Source: Bloomberg.

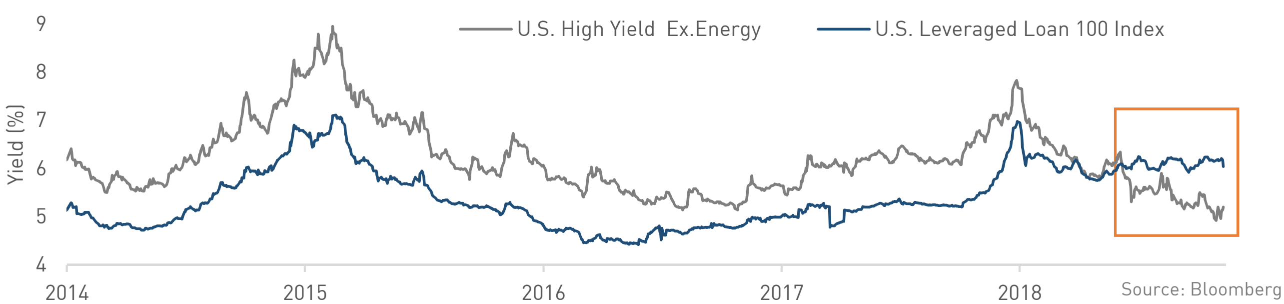
OPPORTUNITIES TO MOVE UP IN QUALITY

This increased demand for higher quality BB issuers over CCC's has also compressed the relative spread between BB's and BBB's leaving little risk premium for crossing the line into high yield. This compression in risk has led us to take profits from some BB holdings which performed well year-to-date, selling into the demand for this 'high quality' section of the high yield market. We have rotated some of this capital into A and BBB rated bonds which offer relatively attractive valuations with lower credit risk. We believe this rotation is prudent given our view that the current risk-on tone maybe shorter-term in nature rather than a signal that the global slowdown will reverse course or that geopolitical uncertainties have abated over the longer-term. We continue to hold high conviction crossover/BB issuers that we believe are relatively insulated from further weakness in global growth but will also perform well if the U.S. economy hits a key turning point to the upside. Our strategies have also found interesting opportunities to own AA and A rated corporate bonds which sit on steep parts of the credit curve thanks to the recent backup in interest rates. The longer end of credit curves (10 to 30 years) sit at multi-year steep levels which allowed us to buy AA/A rated bonds with attractive yields at levels similar to shorter-dated BBB rated bonds but with less credit risk and a hedged duration exposure. Examples included positions in Greater Toronto Airport Authority's 1st lien 2047 bond (AA rated) and Comcast's 2050 bond (A rated). These higher quality positions, combined with interest rate hedges, helped reduce risk while still maintaining an attractive running yield and high conviction BBB/BB positions.

LEVERAGED LOAN DISLOCATION

Another area of dislocation that is offering relative opportunities is leveraged loans. Investors have shunned the asset class throughout 2019 as expectations for lower rates decreased demand for floating rate investments. In addition, weaker covenants and deteriorating credit metrics have made participants cautious to allocate further capital to the asset class (specifically CLO managers, who are one of the larger buyers of leverage loans, have stepped back from the market). This lack of demand has created significant dislocations in the relative value equation between loans and their high yield equivalents with the two having traded in lock-step up until the mid-point of this year. Much like CCC's, we see the lack of demand for lower-rated loans/equity tranches as a reflection of longer-term fundamental concerns from investors. However, unlike CCC unsecured debt, we do see opportunities to put capital to work within the leveraged loan space as we believe some issuers are being unfairly punished by the overall negative market sentiment and lack of demand.

Loans Have Dislocated From High Yield Market and Now Offer Selective Opportunities



Source: Bloomberg
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For RPIA's unconstrained strategy we are now finding selective opportunities in higher rated loans that are liquid but still offer a higher yield than public bond equivalents. It is helpful that our portfolio is starting from a position of strength having owned minimal loans going into the most recent market correction. This "clean slate" allows us to put capital to work in loan issues which offer attractive yields and seniority over high yield public bond equivalents. One example is Staples Distribution 2026 1st lien loan. We note, however, that any exposure in this space only comes after intensive credit analysis conducted by our dedicated credit research team – analysis which is all the more important given the higher leverage and covenant erosion we have seen in this market. Thanks to our in-depth credit work, we can selectively exploit these dislocations by owning senior loans at yield/spread levels that offer much better compensation versus the equivalent BB/B rated bonds whose risk premium has been squeezed out of the market.

Important Information

Indices used include:

Bloomberg Barclays US High Yield BB Index
Bloomberg Barclays US High Yield B Index
Bloomberg Barclays US High Yield CCC Index
Bloomberg Barclays US High Yield Ex. Energy Index
S&P/LSTA US Leveraged Loan 100 Index