Fixed-Income Strategies in Today's Environment

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The following is a summary of a panel held on June 15, 2022.

Alexandre, are you surprised by the Federal Reserve's 75 basis point rate hike today?

- I'm not at all surprised, as news reports suggested earlier in the week that the Fed had indicated it would do exactly that. It's the largest rate hike from the Fed in three decades.
- It seems the Fed was caught off guard by Friday's CPI print.
- The dot plot suggests a fed funds rate at 3.4% for this year, 3.8% in 2023 and back to 3.4% in 2024. Interestingly, the longer-term dots are still at around 2.4–2.5%.
- The hawkish messaging that accompanied the announcement suggested the Fed is strongly committed to bringing inflation back down to 2%.

Elaine, what's your take on the Fed's ability to navigate this difficult environment?

- The Fed doesn't know how sticky the supply side is going to be and they don't know how quickly the consumer is going to react.
- We're in an environment marked by swift and strong emotional reactions to anything the Fed or the government does. This makes it more difficult for the Fed to anticipate where we're going.
- For the Fed to bring the economy down without crashing it, they will need to react to the data, and it's difficult to tell if the market can be patient enough to let them do that. I worry that the market could force the Fed's hand and push them into a direction where they're reacting to markets instead of data.
- It's important to point out that we've now seen a major move in market yield that will start bringing buyers into the market, which should start to put a floor on the downside. We've also had really strong fundamentals and technicals underlying this market, which should be helpful as we navigate this very tough environment.

- One thing that concerns me is the answers we got when we spoke with companies across a variety of sectors about their supply chain issues. The feedback from energy and technology companies was that it would take at least another 12 months from today to get their issues resolved. That means inflation will be sticky for some time.
- The big question for the Fed is: how much pain are they willing to bring about to bring inflation down to 2%? I think they're saying 2% to manage expectations, but I think they're going to be happy with something closer to 3%.

Jeff, do you agree with Elaine that this environment will attract buyers?

- Investors have been starved of yield for such a long time, and I think today you're getting a real return, which has to be attractive for clients who are older.
- If the Fed remains hawkish in order to tackle inflation, securities with floating coupons are going to be very attractive.
- The loan index is down 2.8% YTD, U.S. investment grade corporates are down about 16%, and high yield is down about 13%. The outperformance of loans over bonds is driven by the lack of interest rate sensitivity for loans.
- The loan market has an index average price of $93.73, which is a $6+ discount to par for an instrument that's senior in the capital structure and secured by collateral. The headline yield of the loan index is currently 9.6% and will go higher if the Fed gets even more hawkish.
- Large institutions in the U.S. and Europe are snapping up loans because they view prices as attractive.
- While this is an interesting part of the market to look at, you do have to be mindful of a deep and hard recession and I do think we will see more volatility in the near term.

Jeff, are there any dislocations in the market that you're seeing as opportunities?

- I think it should be emphasized that credit is holding up extremely well relative to the weakness we're seeing in equities.
- In looking at credit, we have to remove the impact of duration on returns – headline returns don't tell the whole story.
- When you look at excess return or credit return, which removes the impact of interest rate sensitivity/duration, the investment grade corporate index is down only 2% YTD (as at June 10), while high yield was down 3.7% YTD and loans are down 2.6%.
- Borrowers raised a lot of capital in 2020 and 2021 when liquidity was high, maturities have been pushed back, and balance sheets have been bolstered. As a result, default rates are very low.
  - At the end of May, the loan and high yield default rates were 0.9% and 0.7%, respectively, versus long-term averages of around 3%.
- Despite the resilience of the credit market, our view is that the path of least resistance is for credit spreads to widen because they're not sufficiently discounting the challenging economic backdrop.
- In an economic slowdown or recession, government bond yields may well fall and absorb any widening in credit spreads, and therefore your total return in corporate bonds or high yield might actually be okay.
- In isolation, corporate credit spreads may not be that attractive today, but from a total return perspective, it's hard to ignore a 5% yield for investment grade or 8.5% for high yield.

Elaine, where are you seeing opportunity in the global fixed-income markets?

- The markets have been very volatile and liquidity has been horrible this year, so we've had to be very nimble when opportunities presented themselves.
- When the technology stock bubble popped almost overnight, that gave us some opportunity within the convertibles market. Some of them are busted, which means we're getting paid as if they're a bond while getting the equity option for free.

- The securitized space, particularly asset backed and some subprime auto, is another area we're looking at – we're buying BBB bonds at BB spreads and yields.
- We have a bit of emerging market exposure, but we don't think now is the time to increase that weighting given the strength of the U.S dollar. Our view is that sometime later this year there will be better opportunities in that space.

Alexandre, are you also encountering low liquidity and do you see it as an opportunity?

- Yes, liquidity has been bad even for Treasuries, which are supposed to be the safest and most liquid securities in the world.
- We run a core bond fund, so most of what we have in credit is investment grade. We're still overweight investment grade credit but have reduced our exposure to the corporate bond space as we think there is more pain ahead for this market given aggressive central bank policy.
- If you look at the Fed's last five hiking cycles, only one ended well, in 1994. I think the odds are against the Fed today given the pace at which they intend to increase the overnight rate. It's likely that we get a recession, though not necessarily a deep one.
- If we see an economic downturn, I expect investment grade spreads will continue to widen. So while we remain overweight, we're waiting for spreads to widen some more before we move further into that market.
- On the provincials side, we prefer to stay close to home. The 30-year Ontario is trading at close to 100 basis points, which seems wide compared to what we've seen the last few years, but we think there's room for further widening. It's an area we plan to increase our exposure to as rates move higher.
- As bond yields have gone up over the last few months, we started to slowly buy some duration; currently our portfolio's duration is longer than that of the benchmark.

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