Opportunity & Risk in Fixed Income

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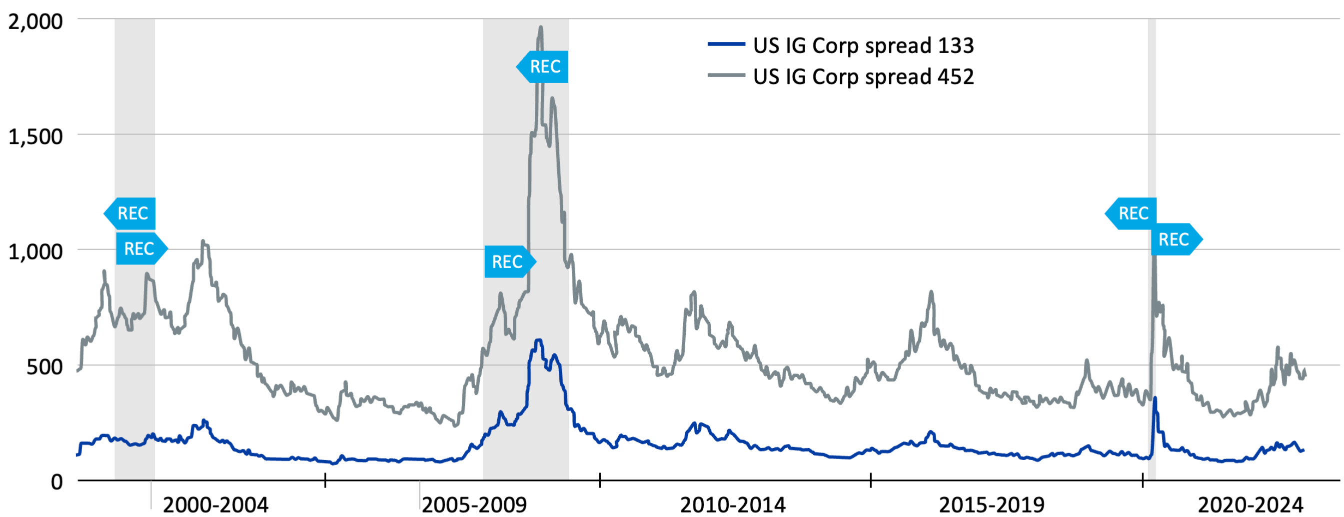
Funds Managed:
IA Clarington Core Plus Bond Fund/GIF
IA Clarington Floating Rate Income Fund
IA Clarington U.S. Dollar Floating Rate Income Fund

The following is a summary of a presentation given on January 16, 2023.

Market Overview

- I think it's very difficult to ignore the attractiveness of the credit markets right now. The key reason is simple: very strong return potential given where yields started the year.
- The strong start to the year for credit has a lot to do with falling risk-free rates and spread compression.
- Credit spreads are not pointing to a recession:

Credit spread in basis points and U.S. recessions



Source: Bloomberg LP on January 4, 2023.

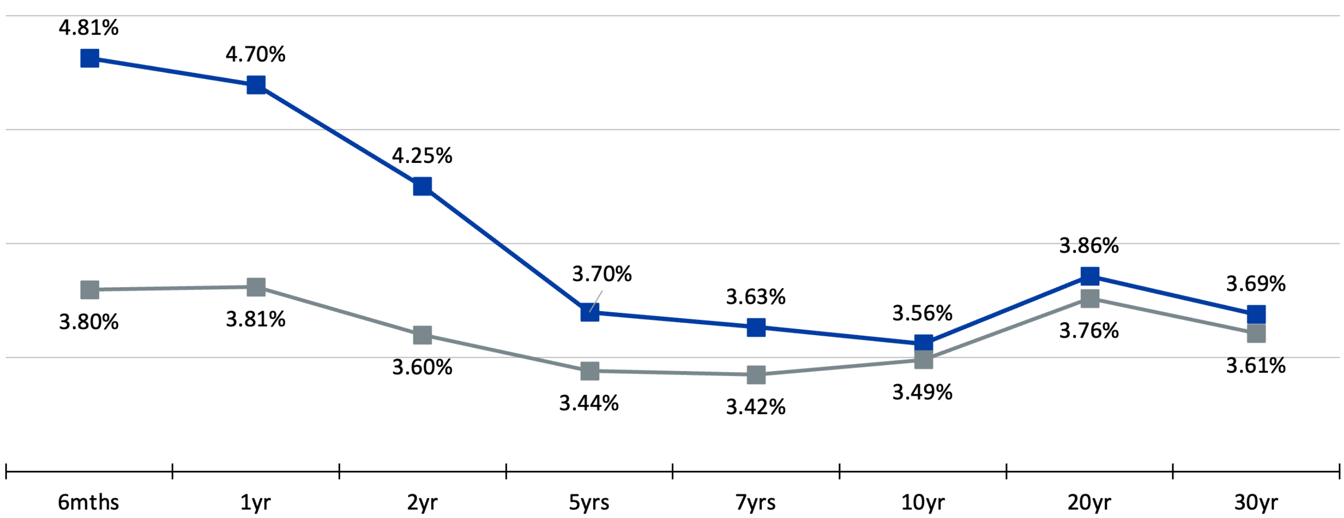
- Default rates ended 2022 at about 1.6–1.7%, which is half the long-term historical average. So, neither spreads nor default rates are signalling a recession. This runs counter to what the majority of economists are calling for and what the market expects – a recession in the back half of 2023.

iA Clarington™ Investments

- E.g., the Federal Reserve's (the Fed) favourite recession indicator, the 3-month/10-year spread, is currently sitting at -112 basis points, which suggests a recession is coming.

- So, on the one hand, you have credit spreads and default rates not signalling a recession, while on the other there are a whole range of other data points signalling that a recession is coming. Is the credit market missing something?
- I think the answer is 'not necessarily,' because if you look beneath the surface of broad spread levels, you can see that the market has already targeted the expected losers: 9.2% of the loan market and 10.4% of the high-yield bond market is trading at distressed levels.
  - The takeaway: if broad spread levels are not pricing in a recession, the risk is that spreads widen and prices fall if there is a recession. As a result, we believe that portfolio positioning should be more conservative with a focus on higher-quality names.
  - It's important to note that when you're looking at higher-quality names it typically means larger tranche sizes, which means more liquidity, and that typically comes with greater short-term price volatility.
  - We believe this price volatility is an acceptable trade-off for the lower risk of permanent loss that comes with higher-quality names.
- When it comes to positioning, we also like to look for parts of the market that are less expensive from a historical perspective.
  - When we look at 20 years of spread history, we find that Canadian investment grade corporates look pretty cheap compared to their historical averages.
- Turning to risk-free rates, I think it's correct to say the Fed is not done hiking rates yet – Fed fund futures are pricing in two additional increases, which would bring the overnight rate to 5%.
- Assuming the Fed does continue to hike, then floating rate assets should look more attractive, though as always astute credit selection is critical.
- If you want to generate your 2023 returns from yield, then you'll want to focus on the front end of the curve (given that the yield curve is inverted). But doing this won't give you the upside you would get from longer-dated bonds in the event that risk-free rates decline.
  - If you plan to give up yield on the front end for the capital appreciation potential of longer-dated bonds, you need to establish an expectation of what that capital appreciation might look like. If you use 1-year forwards as your guide, they're pricing in the 10-, 20- and 30-year at levels that aren't much different than the current spot rate. So perhaps there isn't a lot of room for capital appreciation if you believe the futures market is indicative of what will happen in the next year.

U.S. Treasury curve versus 1-year futures



Source: Bloomberg LP on January 6, 2023.

- Longer-dated bonds are pricing in the end of hawkish Fed policy. This means the risk of adding duration to a portfolio lies in the possibility that inflation remains high, which would mean a continuation of hawkish Fed policy.
- The Fed wants to see unemployment rise because that's how you're going to get the reduced demand that cools down inflation. If we see unemployment stay stubbornly low, then perhaps we haven't seen the end of Fed tightening, which would increase your risk if you position your portfolio towards the long end of the curve.

Q&A

What has the reduction in refinancings done for the dynamics of the credit market?

- The lack of new issuance in the loan and high-yield space is one of the main reasons why we've seen the credit markets doing so well out of the gate in 2023.
- If new issue activity remains low and demand for credit remains robust, you have potential for price appreciation in the form of spread tightening.

Across loans, high yield and investment grade credit, where do you see the best opportunities?

- We're pretty confident that we're getting two more hikes from the Fed, which means interest rates will go up for holders of floating rate securities. This is a positive, of course, but you need to make sure you're invested in borrowers that can service their debt. What you're giving up in this asset class is upside should yields come down – this is where high yield starts to look attractive. From a spread perspective high yield does looks expensive, but from a total yield perspective it's very attractive.
- Regarding investment grade, the argument we hear from investors about being in investment grade corporates is a simple one:
  - o If we have a recession, investment grade assets and spreads will be more contained than the widening in non-investment grade assets.
  - o But you do have more duration in corporate bonds, so if we go into a recession and spreads widen, it should be offset by the decline in yields for corporate bonds.
  - o If nothing happens, then you'll have a pretty tall yield as your starting point and pretty interesting return potential in investment grade.
  - o To the extent that you can buy investment grade assets that have upside potential should rates continue to go up, it would be in floating rate instruments.

What is your view of the opportunity set in private credit?

- We've always liked the private credit space because of the attractive illiquidity premium (i.e., a higher return in exchange for lock-up periods where invested capital cannot be withdrawn). But the public markets are offering some pretty attractive yields and spreads, so in this environment private credit doesn't seem to be as attractive on a relative value basis.

Speak with your advisor to learn more about Jeff Sujitno and the funds he and his team manage for iA Clarington.

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