Q1 2023 Credit Review and Outlook

Short term investment grade improves any portfolio

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The turbulence usually reserved for the equity markets is now prevalent in fixed income markets, led by continued interest rate volatility and recent concerns about banking. In fact, the economic picture painted by interest rate expectations is remarkably dire versus more hopeful equity market valuations.

How should you manage your fixed income portfolio in this environment?

Q1 2023 Recap

During January, risk markets obsessed over economic signals that were interepreted as the tide turning on inflation and ignored central banks tough talk, leading to strong equity performance and a rally in rates. In February the rates rally reversed and most risk markets experienced negative returns. Canadian short term investment grade credit was the outlier delivering a positive month.

In March, troubles at Credit Suisse and two regional U.S. banks led to fear of a system-wide contagion that has not been manifested. Those failures are argubaly the function of poor risk management exacerbated by a rapid increase in rates. Central banks are now forced to factor in financial system stability when making decisions in their fight against inflation. Risk markets gave back gains and Canadian credit reversed early 2023 spread tightening.

YTM realized the benefit of spread tightening while gradually increasing the liquidity and quality of our portfolios. These decisions led to a 50% reduction in our risk from the end of 2022. This active management was timely as we sidestepped some of the spread widening in the second half of March. The running yields of our Funds also absorbed some of the impact.

Q1 2023	Net Return
FTSE Bond Index	3.22%
YTM OM Credit Fund	2.31%
YTM LIquid Alt Credit Fund*	1.61%

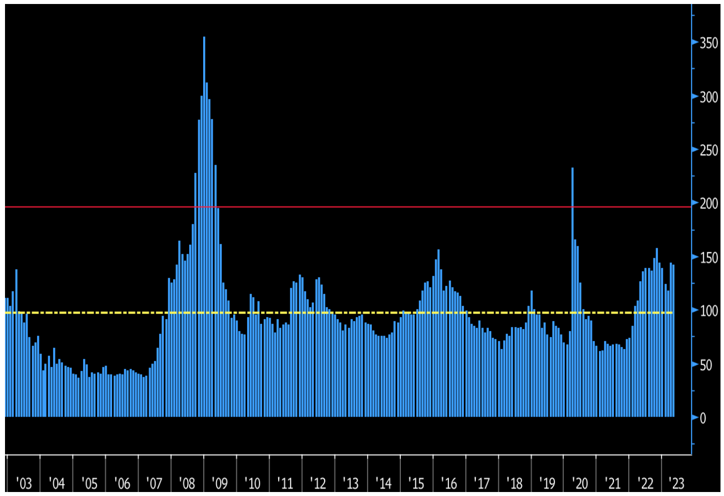
What's Next?

Will the economy slow significantly due to a banking crisis or because the bite of increased rates begins to sink in? In our view, the latter is more likely than the former. Our base case is a moderate recession toward the end of the year.

Fixed income markets have priced in two interest rate cuts before the end of 2023. Implicit in this forecast is that central banks will be forced by a hard-landing economy to reverse course. High yield and equity markets are not currently reflecting the possibility of an economic downturn. In this environment of uncertainty and conflicting valuation levels, diversification is vital.

Canadian IG Credit is Cheap

The short-term Canadian investment grade credit market has priced in a recession. The chart shows that credit spreads are at comparable levels to 2016. Low levels are hard to reconcile with the fact the economy is arguably now stronger than it was in 2016, as are the balance sheets of investment grade issuers. The Canadian market is either overly pessimistic or it is early on the impact of a recession.



Bloomberg Can Agg Corporate 1 - 5 years OAS, Oct 31, 2002 - March 31, 2023. Source: Bloomberg

Another important current factor is that yields on investment grade bonds are high. The implication is that the income paid to corporate bond investors will contribute meaningfully to positive returns if spreads stay the same or tighten and will offset the impact of spread widening.

The red line in the chart above shows the breakeven point for a short-term corporate bond index, including leverage, and the yellow line is the average spread level. Spreads have to widen to levels not seen in the last 20 years, except during true crises, in order for our Funds to stop making money. That is the benefit of the yield buffer. Absent an unexpected macro shock, we do not see this scenario playing out.

The Rest of 2023

The only certainty seems to be uncertainty. If a moderate or severe recession plays out, equities and high yield bonds are at risk of losing significant value and, if central banks hold firm on overnight rates as we expect, there will be losses in the fixed income market due to rising rates. In that scenario investors will benefit from diversification using short term investment grade credit.