2023 was *Annus Mirabilis* for Credit 2024 shows similar promise

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Although a recession cannot be ruled out after a sustained period of rigorous rate hikes, we expect the investment grade credit asset class to perform well, on an absolute and a relative basis in 2024.

Last year

If 2023 credit markets taught us anything, it is that following macro narratives without valuation considerations is like going on a road trip without checking the gas gauge – a fascinating journey perhaps, yet likely to run out of fuel at the most inconvenient time. Entering 2023, the macro narrative was dominated by the likelihood of a recession. As we posed in our 2023 outlook, the material 2022 sell-off in Canadian investment grade bonds (**CAD IG**) widened spreads to levels that reflected all but the most dire of economic outcomes. Our view then was that the macro picture was highly uncertain, but that overly pessimistic CAD IG valuations offered investors a significant margin of safety for left tail events, in addition to significant return potential in a neutral or positive environment.

Fast forward one year and macro events have pleasantly surprised to the upside, credit valuations have predictably mean reverted, and the YTM Capital Credit Opportunities Fund returned 11.28% net during 2023.

2024

As we look forward, we can't rule out a soft landing, but our base case for 2024 continues to feature more persistent core inflation than investors currently expect and a real risk of recession. While remaining focused on the opportunity to generate returns, it is important to be wary of expectations that are not supported by the data. Market and economic conditions will change, as will market internals and asset valuations. Observable and reliable data will also shift and with that so will the opportunity set. Therefore, the following views should be regarded as a snapshot in time rather than a positioning playbook for an entire 2024.

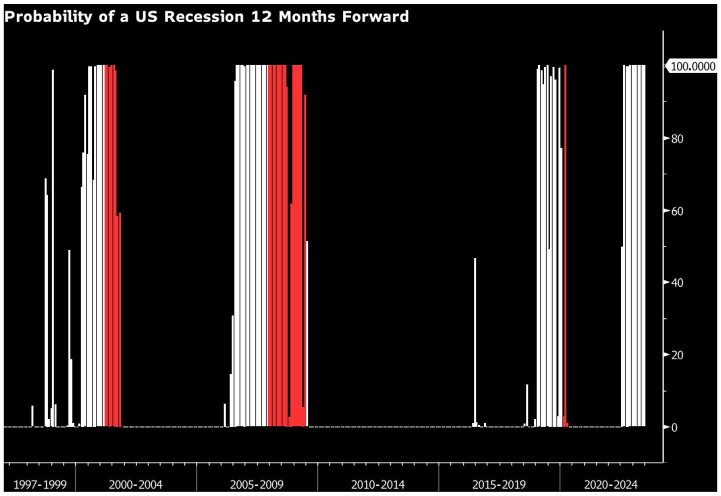
Big Picture

While not as bullish as we were in 2023, CAD IG credit is compelling on a relative basis, and still offers above average return potential over the next 12 months.

Returns will likely primarily be a function of carry because current valuations do not allow much room for spread compression. Although the odds of a "Soft Landing" have increased considerably, we cannot completely ignore historically reliable leading indicators that signal a recession, to which our mandate must yield a degree of caution.

The U.S. Recession Probability model created by Bloomberg is telling. It synthesizes 13 different economic indicators relating to rates, wages, corporate performance and expectations, and economic performance and predicts the probability of a recession in the next 12 months. Since 1996, the model correctly predicted each of the 3 recessions and only created one false positive with a brief incorrect 100% reading at the start of 1999.

The white bars in this chart show the model's calculated probability of a recession and the red bars indicate when a recession prevailed.



Source: Bloomberg

As shown, the lead time from the first 100% reading to the onset of the recession has varied. This cycle's trigger has arguably been delayed due to U.S. consumer strength.

We expect a moderate recession in 2024, not a crash. A short-term spread widening after last year's impressive tightening seems likely, along with a sell-off in other risk assets. That outcome would generate better entry points for credit throughout 2024, allowing us to take advantage of a subsequent rebound. The year will likely have several distinct periods and moods.

We usually like the short end of the curve, and we really like it now

Credit curve flattening was another dominant trend in 2023, particularly in the long end where spreads are historically tight. Limited supply contributed to the flattening along with technical demand. Borrowers were hesitant to issue further out the curve at elevated rates for longer maturity terms, and not unexpectedly, the primary driver of flat spread curves is demand from longer-duration investors like insurance companies and pension funds, especially compelled by the highest yields in years.

We believe that this combination of supply and demand has resulted in the long end of the curve being too flat. We continue to prefer the short end because it offers compelling valuations and break-even levels. For example, at the end of 2023, the 1 – 5 year CAD IG Bloomberg Barclays index offered investors a 1 year forward spread breakeven of 41 bps. In other words, at current yields, a bond could widen 41 bps, or by 37%, before the index would lose money. The 10 years+ CAD IG Bloomberg Barclays index has a 1 year forward spread breakeven of only 13 bps, or an 11% move wider.

That same breakeven analysis for YTM Capital Credit Opportunities Fund, which is focused on the short end, unlike the FTSE Canada Universe Bond Index that is exposed to the entire curve, is also promising. The Fund had a running yield of 9.83%* with a 1 year forward net breakeven of 124 bps. XBB, an ETF that tracks the FTSE Index, has a 1 year forward net breakeven of 58 bps, and it is subject to both rates and credit risk.

Promising New Issue Supply Expectations

Based on our analysis of data from Debt Capital Markets personnel, we expect issuance in the $105-115 billion range for 2024. That said, an expected shortfall of $7 billion created by maturities of and coupon payments on outstanding bonds should create a natural bullish tailwind for the market as more money chases less product.

Our estimate is based on $90 billion of maturities, the expected funding for capital expenditures and pending acquisitions, the continued proliferation of newer types of bank financing, terming out of short-term debt and the ongoing growth of sustainability finance. The realized amount will be impacted by the mix of cross-border issuance mainly by banks, energy, and telcos; foreign issuers issuing maple bonds; M&A activity; potential new issuers; and the rapidly evolving macro/rate environment.

If realized, above average gross new issue volume, combined with strong demand created by a shortfall, presents our Fund with an opportunity to enhance returns.

Positioning our Funds

We anticipated that credit spreads would tighten into the end of 2023 and increased risk by about 75%, starting in October. That decision proved to be a boon for 2023 returns. The legacy of late-2023 tightening is a likely diminished opportunity set for early 2024. We will look to realize gains early in 2024 on much of the risk we added in late 2023.

Importantly, spread direction is only one part of the credit return puzzle, a fact that is often misunderstood. Another key factor is the bond portfolio's carry – or yield. Yield in this context is an investor's net annual return potential if spreads remain unchanged. YTM Capital Credit Opportunities Fund running yield was 9.83%* – materially higher than the Fund's historical average. At this level the Fund's yield provides investors with considerable breakeven support, along with effective absolute return potential.

What is next for Credit?

As we navigate the complexities of the current economic landscape, the potential for a recession is a pivotal consideration in our strategy. If a downturn materializes, we anticipate a widening of credit spreads. Therefore our positioning is defensive. Our focus on securities with high current yields serves as a bulwark, offering a degree of protection against volatility. Moreover, this defensive stance positions us to capitalize on the more favourable entry points that we expect to emerge throughout 2024.

If a recession occurs and interest rates decline, we foresee an uptick in demand for fixed income assets. This increased appetite may mitigate some concerns surrounding credit risk and potential spread widening. The balance sheets of investment-grade issuers remain robust, which is supportive for credit risk and credit quality degradation is not currently a concern.

Conversely, if a recession is averted, we expect credit spreads to either maintain their levels or compress gradually. This environment, coupled with the high current yield of our portfolios, is likely to yield a solid return profile. Our strategic allocation has been designed to thrive in a variety of economic conditions, always with an eye on preserving capital and maximizing returns for our investors.

As of December 31, 2023. *Running Yield is net income assuming that the current portfolio and spreads are static, before fees and expenses are deducted. This estimate is an approximation because (i) individual securities will move differently from the average portfolio move and have different weights in a portfolio; and (ii) the running yield will change during the next 12 months. Net estimated returns can be calculated by subtracting a Fund's management expense ratio, which is approximately 2% for both Funds, plus 15% of any positive returns. Investors should read the Offering Memorandum for YTM Capital Credit Opportunities Fund before investing. You can obtain the OM from YTM Capital Asset Management Ltd. Fund data will change and past performance may not be repeated. Performance is net of fees and expenses, and is for Class F, initial series, distributions reinvested. www.ytmcapital.com