Increasing Rates Continue to Pummel Bonds

Modernize your fixed income portfolio

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As 2021 was coming to a close, we observed that central banks were behind the inflation 8 ball. We predicted that they would have to move aggressively and that traditional long-only fixed income strategies were headed for a rough ride. Those predictions have come true. During the first quarter, the FTSE Canada Bond Universe Index lost 7% and the best performing Morningstar 5 Star Canadian fixed income fund lost 5%.

We have also cautioned, more than once, about a secular shift: after decades of supporting portfolios, traditional long-only fixed income investing simply isn't effective. This rising rate cycle will continue to play out, and wreak havoc, for some time to come.

What's next?

Central banks are signaling more aggressive rate hikes in an ongoing effort to move away from emergency-level rates and to fight inflation and the Bank of Canada increased the overnight rate by 50 bps for the first time in more than 20 years. Market consensus is for more than 200 basis points of rate increases before the end of 2022 and further increases into 2023. While quantum and timing is uncertain, rates are heading meaningfully higher.

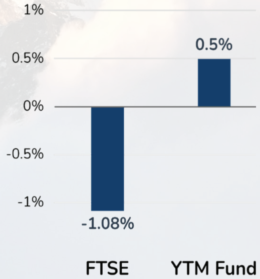
The impact of inflation is the subject of greater debate. Interest rates are a blunt instrument for combating inflation. Rate changes do not address the supply-induced inflation triggered by COVID or the Ukraine war and timing rate changes is notoriously difficult. Given that inflation is a function of unfolding events and an imperfect set of tools, it is impossible to predict if central banks will be able to engineer a soft landing by slowing demand without choking off growth to the point where the economy suffers. Given the strength of the economy from employment, corporate profits, and savings, we believe that the jury will be out on the result of central bank efforts for many months yet.

In this environment of increasing interest rates and continued inflation, where should you look to protect and grow your fixed income portfolio?

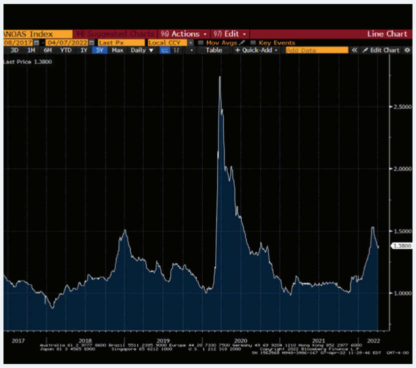
A solution focused on more dependable exposure

Long/short credit strategies remove interest rate risk to isolate investment exposure to the credit spread of public corporate bond issuers. Credit spreads have historically been much less volatile than interest rates. We hedge virtually all interest rate risk in our long/short credit funds.

Exposure to credit instead of rates has consistently generated outperformance. This chart shows the difference in average monthly returns between YTM Capital Credit Opportunities Fund and the FTSE Canada Universe Bond Index when interest rates increased since July 1, 2015. As rates continue to rise, we expect this outperformance to persist.



Another reason to consider long/short credit is that now is a compelling time to be exposed to corporate credit. Credit spreads are at wide levels from a historical perspective. In fact, the current spreads are similar to spreads at the end of 2018 that were pushed out during a set of interest rate increases.



Source: Bloomberg

Wider spreads provide three tailwinds to long/short credit strategies. First, there is potential for capital appreciation if spreads tighten. Second, wider spreads provide for greater returns from carry. Last, new issues are typically issued at wider concessions, creating a higher probability the new bonds will perform well. Those spreads have propelled our Fund's running yield to 5.5%, a level we have not seen in years, and created relative value and new issue opportunities.

We believe that, barring an unexpected macro-shock, the strong economic underpinning will serve as an impetus for pushing spreads tighter, not unlike the credit market of 2019 when the Fund returned 8.86%. Now is a great time to invest in long/short credit.

An all-weather solution

YTM Capital Mortgage Income Fund has an 11 year track record of providing steady returns in a variety of markets through a combination of insured and uninsured mortgage investments.

All of the Fund's mortgages are issued with fixed rates and have short-terms. These factors mean that the Fund's interest rate risk is negligible.

Real assets are generally seen as an inflation hedge, including real estate. The collateral held by the Fund is expected to increase in value in an inflationary environment, thereby providing more protection to the Fund. In addition, the Fund has several structural factors that are meant to mitigate the risk of collateral values decreasing. More than half its portfolio is protected by a Crown corporation, CMHC, or other backstops, making collateral values of much less relevance to securing the mortgages. The other half of the portfolio is protected by low loan-to-value ratios. In other words, we only lend where there is a meaningful cushion between the amount of the loan and value of the collateral. These structural factors give us confidence in the Fund's ability to continue to perform in the current market environment.

Contact us for a comprehenisive Morningstar quantitative review of your clients' fixed income portfolios.

Data as of March 31, 2022. Credit Opportunities Fund returns are for Class F, distributions reinvested. An increase in interest rates is defined to include a month where the yield of the Government of Canada 10 year bond increases more than 5 bps. This document is for information only and is not intended to solicit orders for the Funds. Investors should read Fund OMs before investing. Fund data will change without notice and past performance may not be repeated. **www.ytmcapital.com**

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