Investment Insights

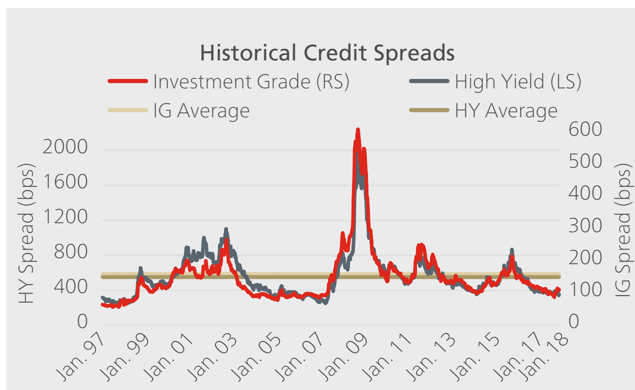
SUMMER 2018

In our last edition of observations on the Canadian credit market, we outlined the benefits of including strategic allocations to both investment grade and high yield credit in investment portfolios. This edition will provide thoughts on the current conditions of the credit markets and a potential solution that optimizes the opportunities and minimizes some of the risks.

Current Spreads

Credit spreads, the difference in yield between corporate bonds and government bonds with a similar maturity, are currently at post financial crisis lows (Exhibit A) for both high yield and investment grade credit. Tactical allocations away from credit are difficult to time based upon valuation levels as spreads can remain at low levels for quite some time (i.e. 2003 – 2007). However, the path for spreads in the medium term is likely wider rather than tighter based upon current levels. This indicates that total returns from a long position in high yield and investment grade credit will likely be muted when compared to returns generated when spreads have been closer to historical averages. Additionally, severe risk-off scenarios when spreads are tight have occurred twice since the financial crisis – in 2011 after the US debt downgrade and in 2015 after the drop in the price of crude oil. The ICE BofA/ML High Yield Master index fell by over 13% during the market turmoil of the 2011 debt downgrade and by almost 10% when crude oil declined in 2015. Although investment grade credit did not experience similar levels of drawdowns during these periods, losses still occurred.

EXHIBIT A



Source: ICE BofA/ML

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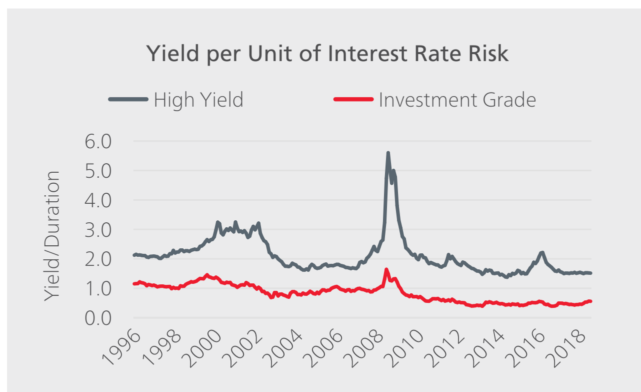
The Future Path of Interest Rates

Anticipated changes in the North American interest rate regime to higher rates is one of the significant concerns for fixed income investors given that interest rates have started rising after being held at artificially low levels since the global financial crisis due to central bank intervention. As per Exhibit B, the reward (yield) per unit of interest rate volatility (duration) is close to historically low levels. Additionally, potentially higher borrowing costs should increase the risk premium associated with credit and move spreads higher. The likely reason for higher interest rates in the future is a rise in inflationary pressures from wage increases and other input costs. An increase in protectionist tariffs enacted by the US administration could be a catalyst that would potentially increase input costs for US manufacturers. As some high yield issuing companies operate on tight profit margins, an increase in costs due to inflation without the ability to pass along these cost increases, could lead to balance sheet instability, erode profitability and raise borrowing costs.

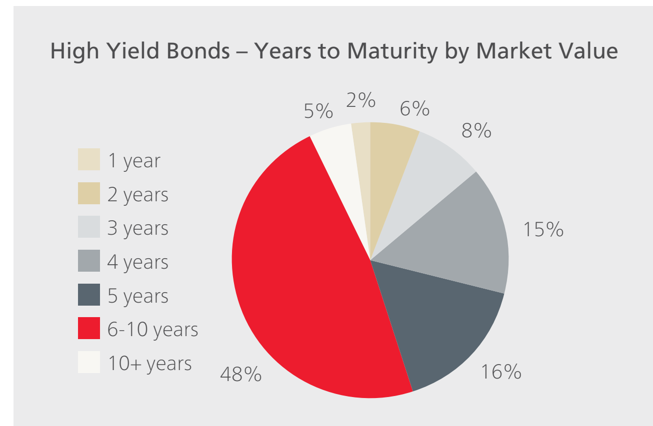
EXHIBIT B



Source: ICE BofA/ML

The prospect for higher interest rates should not only drive bond prices lower, but also raise refinancing risks. In the regime of extremely loose monetary policy, companies have enjoyed the benefit of low rates in financing their balance sheets. Once that debt matures, the prospect of rolling over maturities could potentially become more expensive. However, high yield investors can take solace in the fact that a majority of high yield issuers took advantage of the low rate environment to lock in attractive financing. Only 8% of the outstanding stock of high yield bonds will need to be refinanced in the next 2 years (Exhibit C).

EXHIBIT C



Source: ICE BofA/ML as at 5/31/18

Total Return Opportunities in Credit

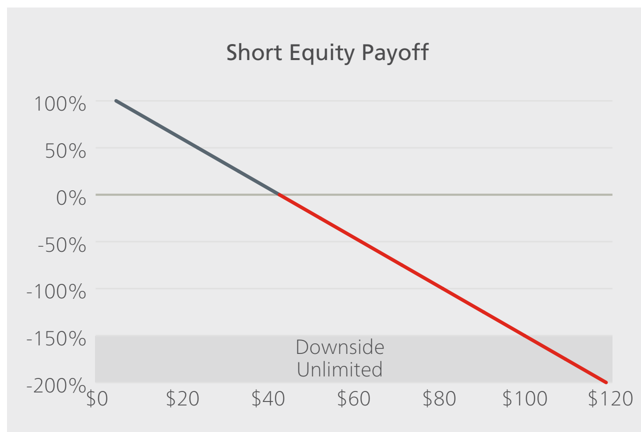
Tight investment grade and high yield spreads along with rising interest rates could create significant headwinds for future returns in long only credit strategies. We'll explore some portfolio management techniques that can be used to navigate a fixed income landscape, which looks increasingly difficult, to generate positive returns going forward.

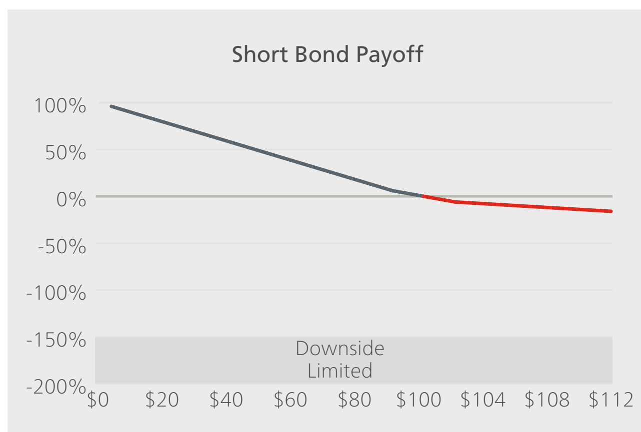
Long/Short Opportunities

Investing in fixed income instruments inherently produces an asymmetric distribution of returns for investors. When held to maturity, the highest annual return that an investor can expect to achieve is equivalent to the yield to maturity when the bond was purchased. However, should a bond issuer default, the worst case scenario for an investor is that they could potentially lose 100% of their initial investment (assuming no recovery). This proposition of limited upside and potentially 100% downside for a long-only investor creates asymmetry. However, this asymmetry is potentially powerful in a total return strategy where

an investor has the ability to be both long and short. When shorting a bond, the investor's downside is limited to paying the yield to maturity on the bond while there is a potential for a 100% return in a default scenario. This is quite different from the potential pay-off from shorting equities as the downside is unlimited. Exhibit D below provides an illustration of the payoff profiles of shorting equities and bonds.

EXHIBIT D





The ability to short both investment grade and high yield bonds provides portfolio managers with the ability to express negative views associated with a credit or to arbitrage market mispricing either with similar companies in an industry or within the capital structure of a company. With recent bankruptcies associated with Toys "R" Us and iHeartRADIO (formerly Clear Channel Communications), there are clear advantages in identifying companies that are leveraged to outdated business models that can be disrupted by technology and innovation.

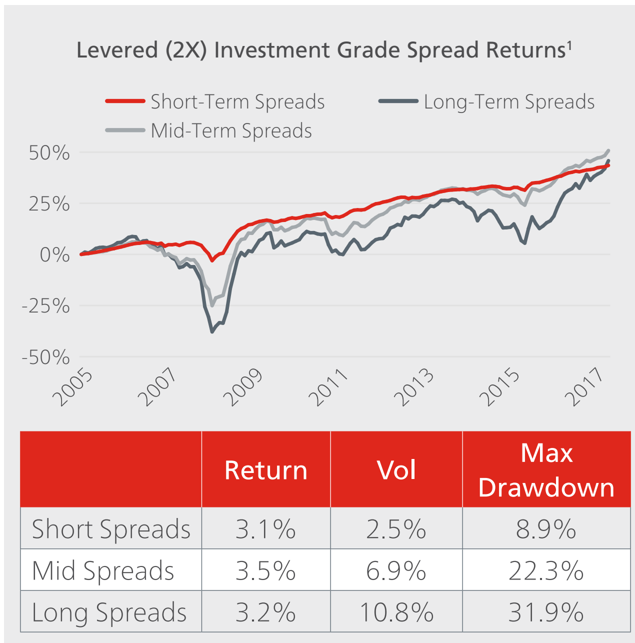
Interest Rate Management

Managing credit within a total return framework also opens the potential for interest rate risk to be managed in order to minimize the impact of rising interest rates. The flexibility for portfolio managers to reduce interest rate risk with shorting bonds or futures can allow for capital preservation in an environment of rising interest rates. Interest rates have declined for the past 30 years and have started to tick up in recent months as market participants anticipate future inflation increases. Based on current valuations every 1% rise in interest rates would cause a decline in the high yield bond market of approximately 4.2% and decline of 6.2% for Canadian investment grade credit, so prudent management of interest rate can have a significant impact on returns. Given that interest rate curves in North America are currently relatively flat, there is little incentive for investors to take on additional interest rate risk.

Opportunities for Leverage

Considering the current level of credit spreads, applying leverage to increase returns at this point in the credit cycle is likely not the most prudent portfolio management technique to achieve stable absolute returns. However, there are times in the credit cycle when spreads are attractive and applying a moderate amount of leverage can provide attractive risk-return attributes. From a financing perspective, the most efficient way to apply leverage to credit spreads is to remove portfolio duration by shorting government bonds with similar duration characteristics. However, we would recommend that leverage be applied to short term credit spreads as this helps to minimize volatility without sacrificing significant returns.
As illustrated in Exhibit E below, the drawdowns associated with levered short term investment grade spreads are muted relative to levered mid and long term spreads.

EXHIBIT E



	Return	Vol	Max Drawdown
Short Spreads	3.1%	2.5%	8.9%
Mid Spreads	3.5%	6.9%	22.3%
Long Spreads	3.2%	10.8%	31.9%

Source: Bloomberg, FTSE Russell, as of 5/31/18

Summary

Declining credit spreads and government bond yields over the past 10 years have provided the perfect environment for outsized returns for credit investors. However, with the current market conditions pointing to higher interest rates and potentially credit spread widening in the medium term, we believe now is the right time to engage credit focused portfolio managers to take an absolute return approach by utilizing the tools and strategies that we have just outlined. We believe that this approach will help to mitigate downside risks while still allowing portfolio managers to pursue attractive absolute returns.

Adam Bomers CFA, Portfolio Manager

We'd love to hear your feedback. For any questions or comments, please contact your Relationship Manager or Bryan DeLaurier (bryan.delaurier@scotiabank.com) at 416-365-2991.

[1] Returns are calculated assuming borrow costs of 35 bps annually to minimize interest rate exposure

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