CUMBERLAND

Private Wealth

FIXED INCOME - FIRST QUARTER REVIEW

The Straw that Broke the Camel's Back: COVID-19

As we started the new decade, traders all over the world had a new bounce to their step - no confidence could be shaken as we ended 2019 stronger than ever with optimism.

The first day back to work– the US made a bold statement with a strike in Iraq which killed the commander of Iran. And so the year began…the rest of the world watched as the drama calmed down from that attack and retaliation – investors' confidence was not rattled. The China/US Phase 1 trade deal was reached mid-January and investors' confidence soared given it had been a year and a half of ongoing tariff escalations that were notably a drag to bottom lines. Much to say, it seemed like the start of the new decade was in the clear and lagging issues such as Brexit (which was finally passed) and USMCA (Trump signed into law) were concluded by the end of January and everyone was ready to move forward.

Then, rumblings of a "flu" broke out in China. The severity seemed so far away (only one province in China was impacted). By the end of January, China announced its plans to start strict quarantines and shut down factories after Chinese new year (early February).

At first, the world brushed this off as a temporary supply issue that would recover relatively quickly as demand around the world was stronger than ever. However, by the end of February, the virus had spread to several countries across the globe and some countries took matters into their own hands quickly and followed China's quarantine regime. No one imagined that this "flu" would be the straw that broke the camel's back.

March Madness – Canadian Economy Codes Blue

Like NCAA basketball, no one ever knows how the 67 game, 6 round tournament will end up: there are many upsets and surprises. This year, however, March Madness gives a whole new meaning for those watching the financial markets. As the virus continued to spread rapidly around the world, the global economic slowdown was very much a reality. Volatility increased significantly: the DJIA Index saw days of 1,000 point moves while government bond yields moved 10bps to 20bps a day; neither of which were the norm.

In addition, WTI oil prices were taking a hit: prices started the year at US$61/bbl and fell to US$45/bbl by March 5th. Saudi Arabia was hoping Russia would agree to further production cuts to support market prices during their March 5th meeting; however, conflict erupted and 2 days later, both instead announced production increases to flood the markets. Oil has since then retreated to US$20/bbl by the end of March.

Exhibit 1: Overnight Interest Rates

Country	March 1, 2020	March 31, 2020	Change (basis points)
Canada	1.75%	0.25%	-150
United States	1.50%	0.00%	-150
Australia	0.75%	0.25%	-50
Brazil	4.25%	3.75%	-50
Europe	0.05%	0.00%	-5
India	5.15%	4.40%	-75
Saudi Arabia	2.25%	1.00%	-125
South Korea	1.25%	0.75%	-50
United Kingdom	0.75%	0.10%	-65

Source: https://www.global-rates.com/

It became clear that the global economy was heading into a recession. As a result, central banks and governments had no other choice but to jump in with emergency responses. See Exhibit 1 for some of the interest rate moves made by the central banks during the month of March.

Canada specifically was even more hard hit due to its dependence on oil, along with rail disruptions during the month of February. With that, there needed to be a coordinated effort between the Bank of Canada and the federal government to resuscitate Canada. While central banks can only do their part by cutting interest rates to stimulate demand, fiscal policy was required to help aid consumers at a time where household income was becoming a risk. So, in lock-step with the Bank of Canada, the federal government stepped in to help revive the economy with fiscal stimulus. Exhibit 2A and 2B outlines the monetary and fiscal policy measures Canada has taken to help battle the virus.

Exhibit 2A: Resuscitating the Economy – Canadian Monetary Policy Measures

03/04: BOC cuts interest rates by 50bps to 1.25% during its scheduled meeting

03/12: BOC announced expansion of bond buy back (across the yield curve) and repo operations to improve market liquidity – details to be determined

03/13: Emergency meeting - BOC cuts interest rates by 50bps to 0.75%

Announced plans to improve bond market liquidity which included introduction of:

- A Bankers' Acceptance (BA) Purchase Facility
- Standing Term Liquidity Facility ("STLF") to provide loans to financial institutions that need temporary liquidity support
- OSFI reducing Domestic Stability Buffer requirements for the banks to 1% of risk weight assets from 1.25%

03/16: BOC furthered announced plans to:

- Broaden eligible collateral to its terms repo facilities to include full range of securities in STLF
- Purchase Canadian Mortgage Bonds (CMB)
- Give financial institutions more flexibility in managing collateral under its STLF – assigning up to 60% of non-mortgage loan portfolios

03/18: BOC announced plans to:

- Allow financial institutions to assign 100% of non-mortgage loan portfolios to it's STLF (from 60% announced)
- Broaden eligible collateral further for repo facilities to ABS and ABCP

03/20: BOC implemented additional measures:

- Increase frequency of term repo operations
- Activate a Contingent term repo facility; and
- Launch a USD term repo facility if needed

03/23: More tweaking

- BA Purchase Facility – maturities include up to 3 months, first purchase March 30th of up to 20bln.
- Banks treasury auctions will increase from bi-weekly to weekly (15 auctions in total)
- Bank term repo operations include temporarily BA and promissory notes

03/24: Added a Provincial Money Market Purchase program to buy up to 40% of provincial bonds in primary markets with maturities less than 1 year

03/27: Emergency meeting - BOC cuts overnight interest rate by 50bps to 0.25%.

- Introduced a Commercial Paper Purchase program
- Will buy 5bln of Government of Canada bonds in secondary market a week (up to 200bln)- BOC's first Quantitative Easing in history.

03/31: Details of 5bln/week Government of Canada bond repurchases were released (timing and terms to be bought, but size to be determined still). First purchase to be made on April 1st.

March

BOC = Bank of Canada

Source: Complied from https://www.bankofcanada.ca/ releases

Exhibit 2B: Resuscitating the Economy – Canadian Fiscal Policy Measures

03/11: Prime Minister Justin Trudeau announced a $1bln package to fight COVID-19 inclusive of:

- $500MM for provinces to buy equipment
- $275MM for research and vaccines

03/13: Finance Minister announced a $10bln credit facility to lend to companies affected by COVID-19

03/18: Federal government announced a $82bln stimulus package (~3% of GDP)

- $27bln in direct fiscal stimulus
- $55bln in tax payment deferrals by corporations and individuals until September

03/23: Government announced Farm Credit Canada's lending capacity is increased by $5bln and farmers under the Advanced Payment Program will be allowed a 6 month extension in repayments.

03/25: Federal government increased the direct fiscal stimulus budget from $27bln to $52bln.

03/27: Federal government announced more measures to support small business: a wage subsidy program for 75% of wages for 3 months and guarantee $65bln in loans for small and medium sized businesses.

Fiscal stimulus is now ~7% of GDP

March

BOC = Bank of Canada

Source: https://www.canada.ca/en/department-finance/economic-response-plan.html

The Canadian Bond Market Has a Serious Infection

Both COVID-19 and the drop in oil prices definitely spooked investors as uncertainty of both the duration and depth of the recession caused investors to flee from both the equity and bond markets. Then with equity markets down as much as 30% during the month of March, outflows in the bond markets continued as balanced mandates rebalanced their asset mixes. As investors piled in to liquidate from bonds, the bond market became illiquid – the infection was serious.

Two main things have been happening:

1. **Price Dislocations:** Canadian bond markets are not traded on an exchange but rather over the counter. Because we were seeing a flood of sellers into the bond markets and a limited number of buyers, bond price movements were amplified. Bond markets are similar to the housing market – prices clear to the highest bidder (if any), and if there are no bidders, prices keep adjusting downward. In this environment, sellers try to sell their highest quality bonds or shortest to maturity bonds thinking those bonds will fetch better prices; however, every seller has that same thought process, which caused an oversupply of both higher rated bonds and/or short maturity bonds in the market and bond prices being severely penalized anyways.

   As a result, to restore liquidity in the markets, the Bank of Canada announced they would be repurchasing bonds in the secondary markets to act as a backstop or participating in the primary market to ensure money can be raised. See Exhibit 2A above for more details on which segments of the bond markets the Bank of Canada is trying to heal first. Currently, there is no formal repurchasing program for the corporate credit market (outside of money market type securities) and thus the corporate credit market is illiquid. However, the Bank of Canada is first addressing the markets that are typically most liquid to begin with (ie. banker's acceptances, government bonds, repo markets) to ensure those are functioning well first, then will fix the other parts of the bond markets. Hence, we believe it is only a matter of time that the Bank of Canada will purchase corporate bonds if the liquidity does not fix itself.

2. **Deteriorating Credit Quality:** Not surprisingly, because of a slowdown, companies are seeing a decline in revenues, lower margins and higher leverage ratios, resulting in downgrades to their credit ratings. However, companies have learned from slowdowns in the past. While this is not like any other crisis experienced in the past, we are entering this slowdown with stronger balance sheets (as many Canadian companies have been on a leverage reduction track over the past few years) and experienced management teams having been through slowdowns before. Over the last few weeks, many companies have been quick to react in securing liquidity which included: drawing down on their credit facilities to hoard cash; restructuring credit facilities to enable them to have access to cash; cutting back on growth capital expenditures; reducing workers or management compensation to minimize costs; and/or cutting dividends/distributions. Many management teams have had investor calls to speak about their efforts on how they will function through this tough period. While credit ratings will hopefully improve when the infection is gone, it may take some time to recover.

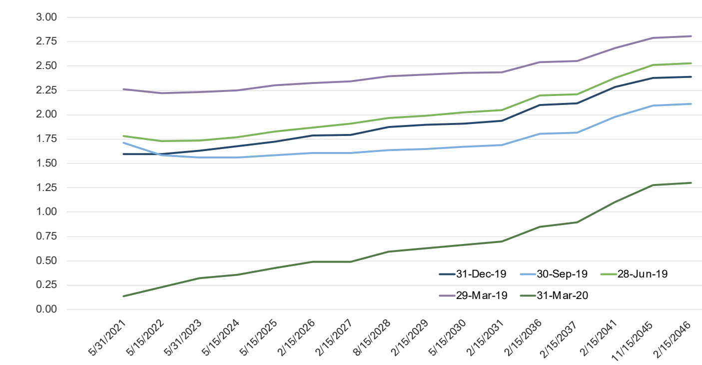
Quarter Review

During the quarter, the Fed cut interest rates two times during two emergency meetings held in March (50bps and 100bps) and skipped their scheduled meeting on March 18th. The US' overnight interest rate range is now 0% to 0.25%. The Fed noted that negative interest rates is not their intention.

With a $2 trillion fiscal stimulus package that was approved by the US government at the end of March, much of it will be funded by debt (given they were already in debt from the last fiscal year).

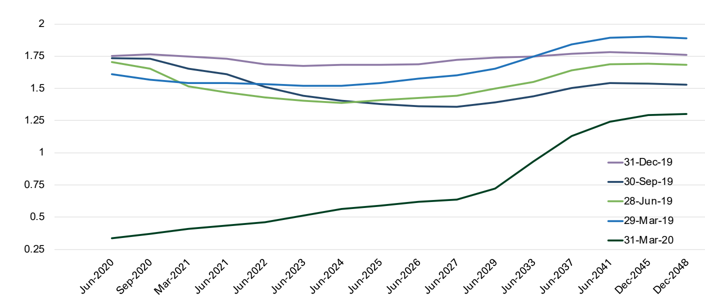
Interest rates for the quarter moved anywhere from 109 basis points (bps) to 146bps lower across the curve. The yield curve also steepened, with the difference between the 2-year government bond yields and 30-year government bond yielding increased from 80bps the end of Q4/19 to 107bps at the end of Q1/20.

Exhibit 3: US Yield Curve



Source: Bloomberg

Exhibit 4: Canada Yield Curve



Source: Bloomberg

The Bank of Canada made their first of three 50bps interest rate cuts during their scheduled March 4th meeting, followed up with two emergency meetings on March 13th and 27th, leaving overnight interest rates at 25bps at the end of the quarter. Governor Poloz, whose term ends on June 2, 2020, noted that the Bank of Canada is not contemplating negative interest rates at this point.

With WTI oil prices at US$20/bbl, packaged with COVID-19, the outlook and sentiment for Canada was very pessimistic. Interest rates for the quarter moved anywhere from 45 bps to 140bps lower across the curve. The yield curve was steeper as the difference between the 2-year government bond yield and the 30-year government bond yield increased to 84bps from 7bps at the end of Q4/19.

Market volatility has been unprecedented: in the month of March, the 10-year Government of Canada bond swung by 53% from peak to trough (vs. 46% during all of 2019). For the quarter, that same move was 68% in aggregate.

Canadian investment grade corporate spreads were wider anywhere between 87bps to 173bps across the curve and rating categories during the quarter, with most of that spread widening in March. Specific sectors were hit harder, such as Energy and Autos which saw widening of 200 to 700bps.

Returns for various fixed income asset classes are shown in Exhibit 5.

Outlook & Strategy: Post Traumatic Stress Disorder?

NO. People have fled the asset class during this chaos - for those that want to lock-in higher yields, this is the time to be choosy. Stay calm.

What we do know is this:

1. Infections in Canada and US have not peaked as some people are only now starting quarantine periods and testing has become more available in the last couple weeks;
2. Price of oil could be low for a while; and
3. Downgrades and defaults will increase over the next 12 months from what we saw in the last 12 months.

Exhibit 5: Returns for Fixed Income Asset Classes

Asset class returns	Q1/20	Q1/19	2019	2018
Bond Universe Index	1.56%	3.91%	6.87%	1.41%
Corporate Bond Index	-2.48%	4.03%	8.05%	1.1%
High Yield Canadian Index	-31.55%	4.02%	8.48%	2.15%
S&P/TSX Preferred Index	-24.86%	0.78%	1.99%	-12.21%

None of the above sound optimistic; however, in a state of chaos, there are always opportunities as people become irrational. In addition, there have been both monetary and fiscal measures put into place to soften the blows, along with companies who have reacted quickly to shore up liquidity.

In my last few commentaries, I have always noted that bonds were getting expensive and trading well above par (ie. 100). At the end of 2019, 89% of the bonds in the Canadian Bond Universe traded above par, now 79% of those bonds trade above par and generally are lower in price. While some of the bonds in our portfolios have also repriced with the market to trade below par, the losses are not cemented (or realized). When bonds mature, they are paid back at par. So, in the meantime, while we wait for these bonds to mature and prices to recover, there are definitely more opportunities now to put money to work in bonds that are better value and potentially better quality (anywhere from 200 bps-400 bps higher in investment grade) than we saw at the beginning of the year.

We continue to be opportunistic and selective with respect to the fixed income investments we are adding to our portfolio. There is no doubt that there will be some companies that will not survive this slowdown, but not all companies are going to falter to bankruptcy or even default. Our strategy in analyzing companies has not changed as we continue to focus on their ability to generate and conserve cash, their ability to repay bonds and the triggers a company can pull to avoid default. We continue to assess and understand the risk/rewards.

The yield curve (and interest rates) are lower but the yield curve has steepened; while credit spreads are wider but the credit curve is now flatter, or in some cases inverted because of the price dislocations described earlier. As a result, we continue to be biased to find the best risk-adjusted returns, which may still lead us positioning in short maturity bonds.

I hope everyone is in good health.

Take Care,
Diane Pang

Diane

Lead Manager,
Cumberland Fixed Income*
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*Cumberland Private Wealth refers to Cumberland Private Wealth Management Inc. (CPWM) and Cumberland Investment Counsel Inc. (CIC). Diane Pang (a Portfolio Manager at CIC) is the lead portfolio manager for the Cumberland Income Fund and the Kipling Strategic Income Fund. NCM Asset Management Ltd. (NCM) is the Investment Fund Manager to the Kipling Strategic Income Fund. CPWM, CIC and NCM are under the common ownership of Cumberland Partners Ltd.