October 2021

# Back to School

It seems like life is getting back to normal. Students are back to class in person. Sports fans are returning to packed stadiums and airport checkpoint travel numbers are approaching 2019 levels. Economists, on the other hand, are attending the new movie thriller: "Transitory Inflation". How the current level of inflation, which hasn't been seen in decades, will affect the path and structure of the global economy is clearly not just an academic exercise. It's real and hopefully doesn't resemble the slasher movies that rear their head this time of year. Bloody and bad.

We believe risk markets (stocks and credit) are generally overvalued. Yes, we've said it before and yes, they could continue to be expensive for some time. Nevertheless, two recent headlines from the Financial Times sum it up well: "New companies raising cash swell US junk bond market to record size" and "Bond fund managers stay on guard against inflationary risk".

In circles we travel, it is believed that non-investment grade corporates ("junk bonds") are the best hedge against inflation. Yet, when high yield companies are issuing debt at historic levels, with interest rates still close to all-time lows and record inflation, we have a really really (for emphasis) hard time believing there won't be a price adjustment (hint… it's not up).

Yields and spreads for investment grade and high yield bonds have migrated little from their all-time low range this year. Technically, this would suggest movements tighter (prices higher) are unlikely.

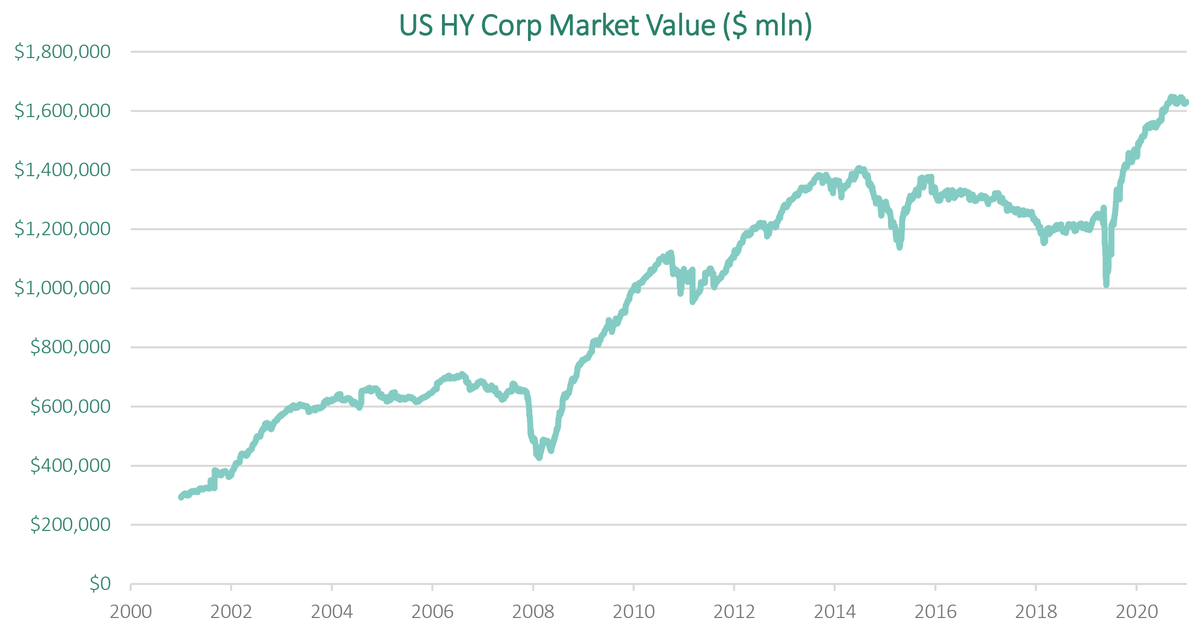
Since the 2nd quarter of 2020, there has been an extraordinary level of monetary and fiscal support that has reduced yields and supported the profitability of corporations.

Not to dispute the merits of their actions, but such Government and central bank aid, which has occurred twice over the last 12 years, should strongly suggest they will be saviors in future crises. Nevertheless, something must give to restore the essence of free markets or else every company and citizen becomes beholden to the state … or the FAANG's…now MAANG's.

Distressed corporate bonds are those that yield more than 1,000 basis points over government bond yields. This segment of the corporate bond market has shrunk in size due to both the low level of interest rates and the strong bounce back in the economy that has helped support some of even the most levered of corporations.

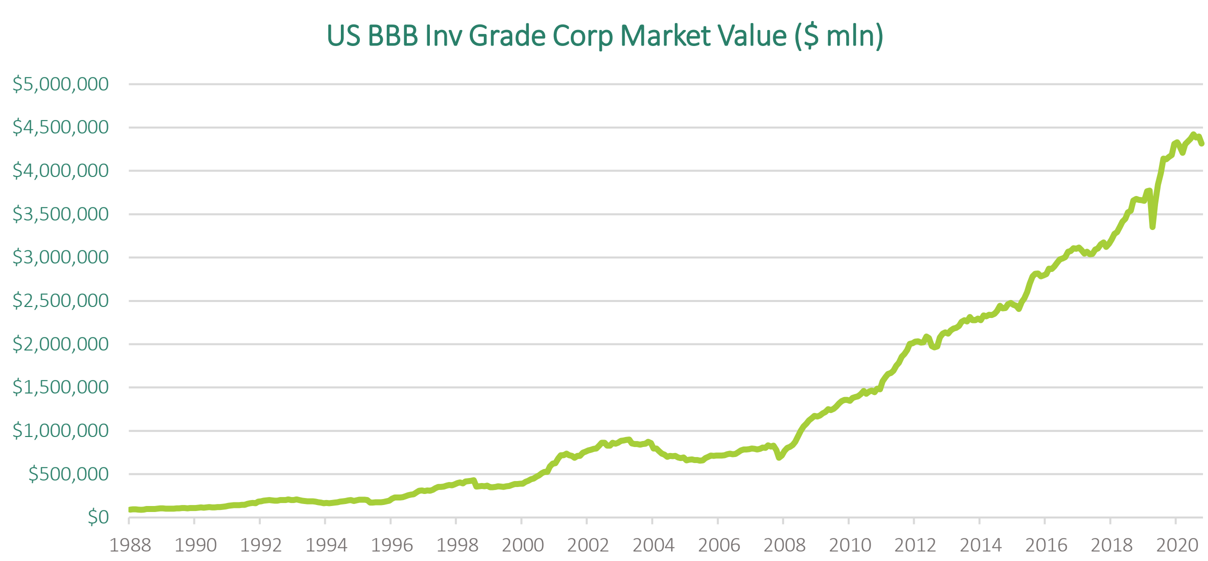
*Source: Bloomberg Finance L.P.*

Fortunately, for patient deep value investors, this is not the harbinger for future opportunities.




*Source: Bloomberg Finance L.P.*

The total size of the High Yield market (above) and low-investment grade (BBB) market (below) are much more indicative of the potential opportunities that lie ahead.




*Source: Bloomberg Finance L.P.*

Despite the popularity and growth of private credit and the veil of its safety, due to the lack of mark to market, it has not dinted the robust growth of public credit markets.

While the market might say ‘No’, we have found some opportunities under the surface that say ‘Go’ and play to our sensibilities of focusing on shorter duration bonds with a catalyst. The Osisko Gold Royalties convertible bond due in December 2022 is such a situation. Osisko is in the business of acquiring gold and other precious metal royalties, streams and similar interests primarily in Canada. These types of arrangements provide mining companies, both producing and developing, financing from companies like Osisko in return for selling future production or revenues. It is a form of mining investing that has grown in popularity as public markets have become relatively less supportive of small to mid-size operating and exploratory mining companies.

In our opinion the Osisko convertible bond is attractively priced for 3 reasons. Firstly, the convertible is covered by the liquidity on its balance sheet. Secondly, based on the first point and the price we paid for the convert; the downside is a 2.6 percent annualized to the December 2022 maturity. Thirdly, and more interestingly, the Osisko bond is convertible into Osisko stock and, based on the recent performance of the stock, we believe there is a reasonable prospect that the bond could trade higher in tandem with the stock.

While we aren’t gold bugs, admittedly, we are less of a bitcoin bug and do think the Osisko convert is an attractive capital markets volatility hedge in a market that is generally absent value.