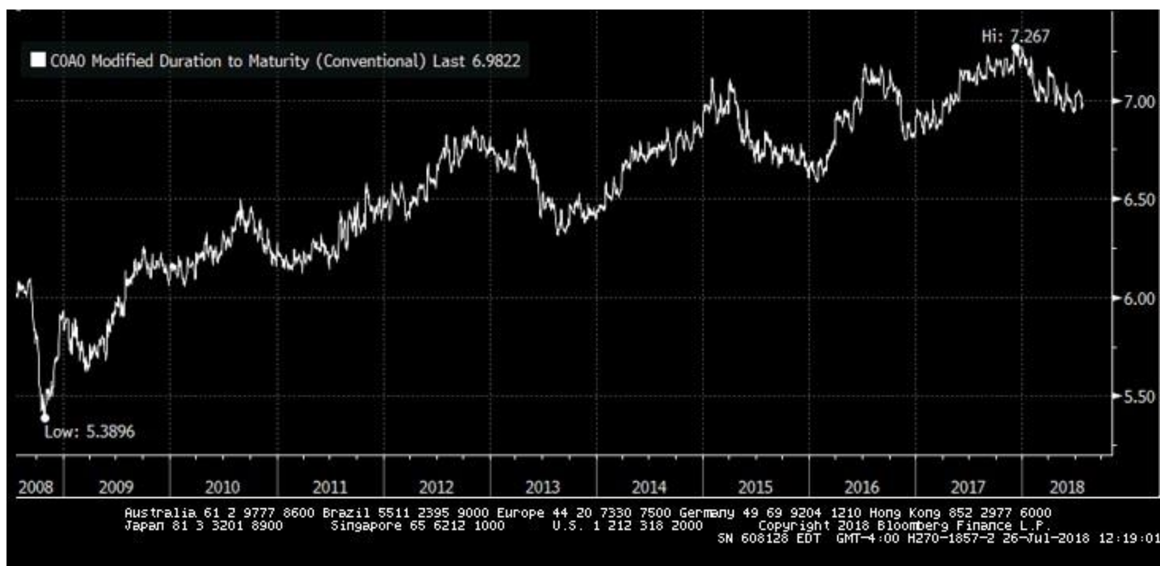
July 26th, 2018

Is Timing Everything?

Observers of the Investment Grade market would answer affirmatively. Over the course of the first 2 quarters of the year, the US investment grade Index[1] was down 3.1 percent while the shorter duration US high yield index[2] fared slightly better, being up 0.08 percent.

If the year to date losses continue for the remainder of 2018, US investment grade will experience its 2nd worst year of performance since inception in 1973. Interestingly, the worst year of performance, 2008, was due entirely to widening risk premiums (spread) where thus far in 2018 a large contributing factor to negative performance to date is due to the rise in government bond yields.

As the below chart highlights, the US investment grade market has seen the average bond duration rise steadily since the Great Recession (2008 -2009) to over 7 years. This means the US investment grade bond universe has become considerably more sensitive to potential interest rate movements over the last decade.



[1] ICE Bank of America/ Merrill Lynch US Corporate Index
[2] ICE Bank of America/ Merrill Lynch US High Yield Index

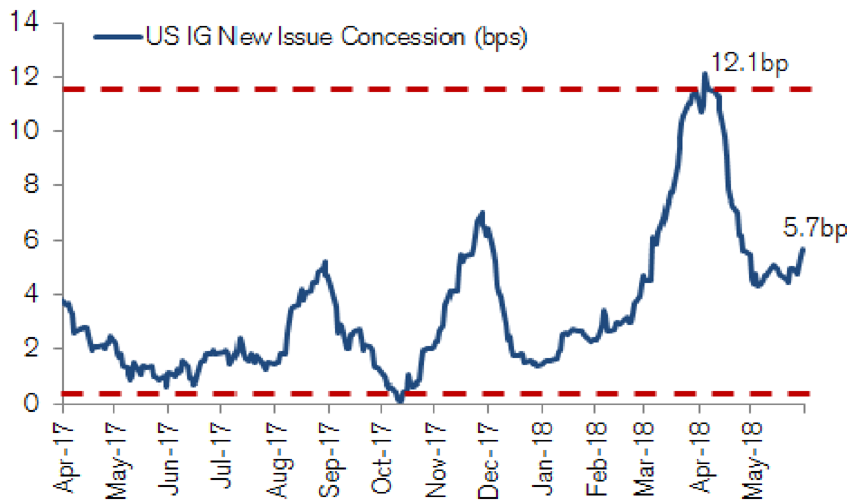
Fulcra Asset Management Inc. | Suite 950 – 609 West Hastings Street, Vancouver, BC | V6B 4W4
Tel: (604) 683-8362 | Fax: (604) 683-8368 | Email: info@fulcraam.com | Website: www.fulcraam.com

In the first half of 2018, Treasury yields[3] went from 2.2 percent at the beginning of the year, to 2.72 percent by the end of the 2nd quarter generating a negative 1.15 percent return over this period.

While the increase in Treasury yields explains some of the negative return for Investment Grade, it was spread widening of 32 basis points that caused the bulk of the negative investment grade return year to date.

The graph below shows that concessions given to buyers of investment grade corporate new issues has increased dramatically since the beginning of the year. In other words, investment grade investors have required a higher level of coupon to be persuaded to buy a new issue, suggesting that investors have been expressing a reluctance to buy investment grade corporates.

Concessions continue to be elevated

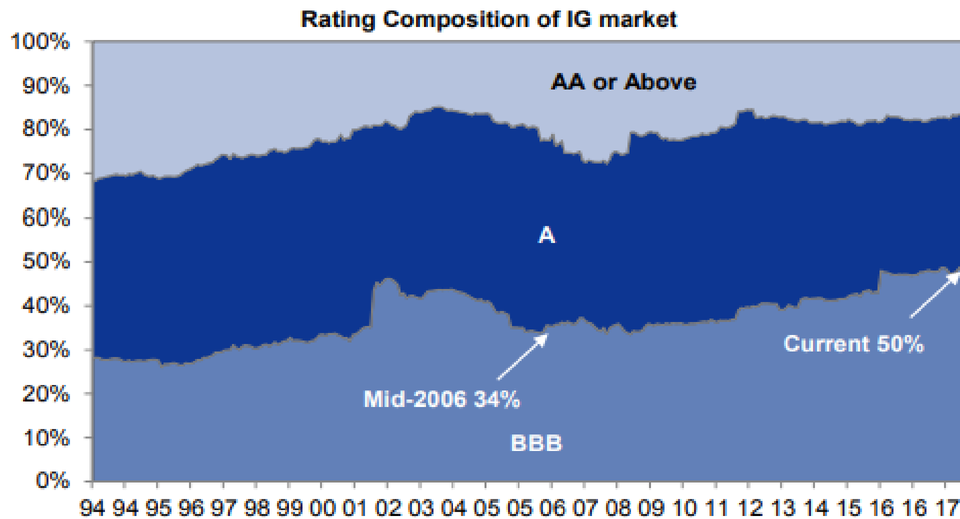


Source: Credit Suisse

As Investment grade corporate bonds are on average longer in duration than 6 years ago, the increase in interest rates in the first quarter simply reminded investors of that sensitivity, enabling them to ask for more compensation (higher coupon). Some investors may see this as a concern that economic growth is stalling and lead to credit metrics being negatively affected. We are not of this view.

[3] ICE Bank of America/ Merrill Lynch US Treasury Index

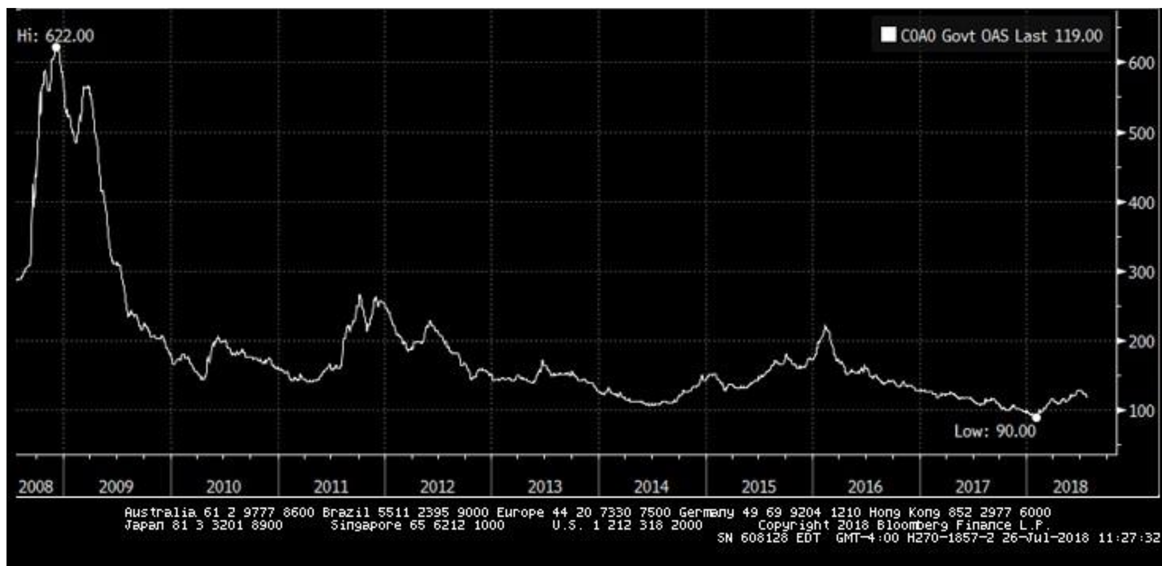
Nevertheless, it is important to mention that the overall quality of investment grade corporate bonds in the US, based on credit rating, has decreased over time as highlighted by the higher percentage of bonds in the BBB category.



Source: The Yield Book FTSE-Citi index, Goldman Sachs Global Investment Research

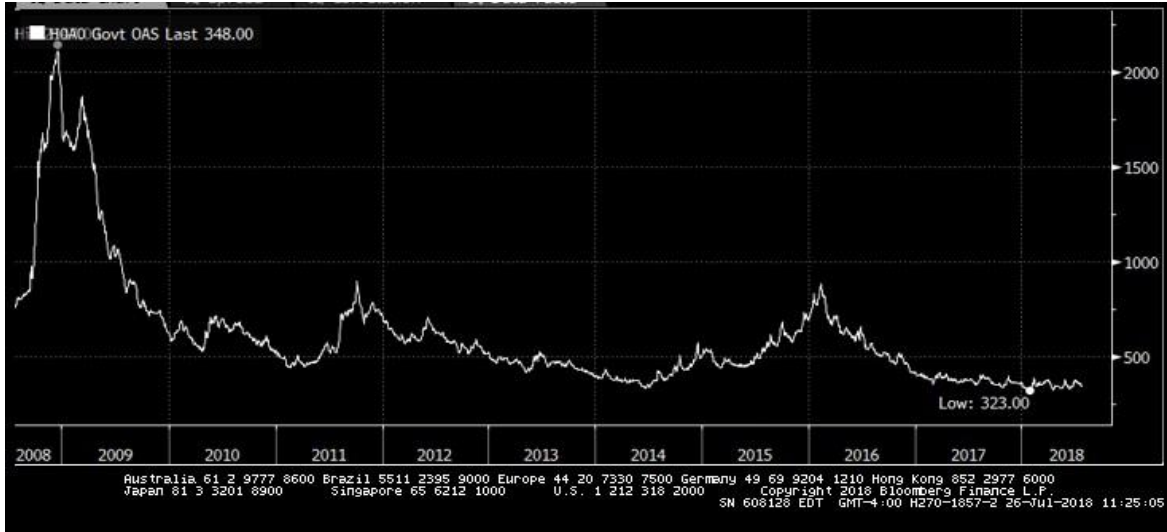
We believe both the investment grade and high yield corporate bond markets are rich. The spread graphs below show that earlier this year both markets hit their lowest levels in the last 10 years.

<u>US Investment Grade Corporate bond spreads</u>



FULCRA
ASSET MANAGEMENT INC.

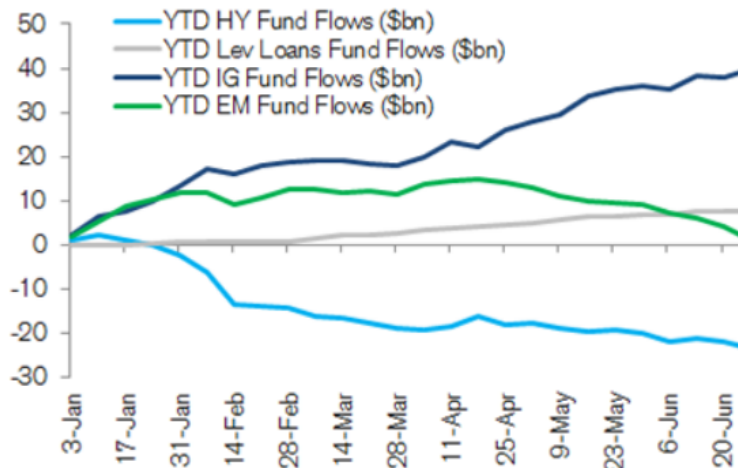
US High Yield Corporate Bond Spreads



Despite a slight increase in spread levels over the last few months we don’t think today is a good time to be taking on market risk.

Given that the Lysander Fulcra Fund has an absolute total return benchmark of 5 percent, we can choose to avoid this market risk by not feeling pressure to buy broadly held index bonds.

Fulcra’s primary focus is protecting capital and locating idiosyncratic opportunities. To this point, Fulcra has recently found opportunities in the hard yield to call market.



Source: Credit Suisse, EPFR

As you can see in the graph, on the previous page, there have been outflows from US high yield funds in 2018. As Exchange Traded Funds and many fund managers are fully invested, they generally need to sell an investment when they are hit with redemptions. One type of situation where we have seen selling is in "hard" yield to call bonds.

These are bonds where a corporate action has been sent to bond holders indicating that the company will be maturing the bond in 30 days at a predetermined price. At certain times this year, during periods of high yield outflows, there has been selling of these "hard" yield to call bonds.

Fulcra has been able to buy these bonds at annualized yields of 2.75 to 3.30 percent for 2-3 week holding periods. As there is little interest rate and credit risk, we find these investments to be an excellent cash proxy and return generator that keeps the door open for us to still pounce on broad market and idiosyncratic opportunities.