



## New Decade and The Search for Value Continues...

The US Federal Reserve's shift to a more dovish interest rate stance in early 2019 helped fuel the S&P 500 to a return of 31.8 percent for the year<sup>1</sup>. Similarly, other risk markets like the US High Yield bond market performed with equal aplomb, up 14.4 percent<sup>2</sup>.

This robust return left the S&P 500 at the end of 2019 with a trailing price earnings multiple of 21 times. Once all S&P 500 constituent companies have reported their Q4 earnings, earnings growth is expected to be flat to slightly negative for 2019<sup>3</sup>.

### **Equity Valuations very rich ...**

However, analysts' expectations are for earnings to rise well above 10 percent in 2020. Specifically, as of Friday Jan. 24th, the index was trading at an index level of 3,295 which based on expected earnings for 2020 of \$175 is trading at approximately 19 times forward earnings. At this level stocks are trading at levels not last seen since the internet bubble era 20 years ago<sup>3</sup>.

### **as well as US High Yield corporate bonds.**

Not surprisingly the US High Yield bond market is also trading at an equally lofty valuation. At year end High Yield was yielding 5.4 percent<sup>4</sup>. This represented 370 basis points of additional yield ("spread") above US government bonds.

Interestingly, the yield on Jan. 24th was also 5.4 percent<sup>4</sup> but given a decline in government yields since the beginning of the year the spread was 384 basis points. Not a meaningful pick up in spread but the equity market (S&P 500) was up 2.41 percent over this period. To spare you doing the math, this is the equivalent of a 41.41 percent annualized return. Think Ben Johnson, Seoul Olympics. The drug? Lower interest rates.

Yes, the current spread today is higher than the low levels of additional yield the US high yield bond market was offering in 2007 when spreads were below 300 basis for several months. Back in the days before the great recession, the yield on US High Yield bottomed at 7.3 percent and government yields were substantially higher at 4 to 5 percent for the 10-year US Treasury bond compared to 1.5 to 2.5 percent for this past year<sup>5</sup>.

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<sup>1</sup> Dividend Reinvested | Source: Bloomberg Finance L.P.

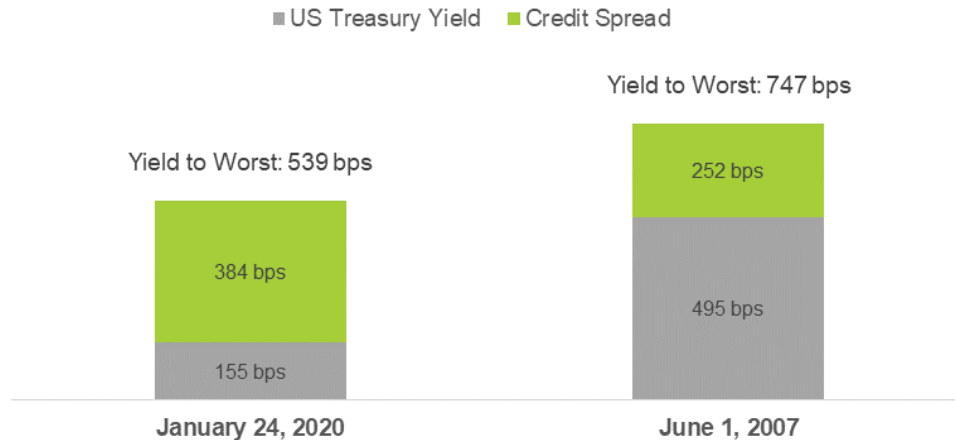
<sup>2</sup> ICE BofAML US High Yield Index | Source: Bloomberg Finance L.P.

<sup>3</sup> Source: Bloomberg Finance L.P.

<sup>4</sup> Yield to Worst

<sup>5</sup> Source: Bloomberg Finance L.P.

### US High Yield Risk Premia: Present vs. Past Basis Points (bps)



### Investment Grade and High Yield corporate bond leverage at all-time highs

According to Goldman Sachs Credit Strategy Research, net leverage ratios for the median non-financial Investment Grade and High Yield (ex-commodity) companies was close to 2-decade highs at the end of Q3 2019. Interestingly, this was not a result of an increase in debt but a result of weak profitability. Not a surprise given the flat to negative earnings growth seen in S&P 500 companies in 2019. While companies may be able to service their debt today, at some point in the future when the time comes to refinance this debt, higher interest costs, or the perception of them, will make it punitive for companies to roll over debt at the coupon and maturity they were expecting.

### Credit market volatility to pick up with rates or recession

We make the point frequently that given the higher level of debt in the High Yield asset class, investors should target absolute compensation not relative. This may seem contradictory to yield focused bond investors, but High Yield corporate bond investors can't expect to receive any more at maturity than an investor that owns a US Treasury bond. At times when prices are high, like the current environment, any risk off fears due to a recession or risk on trend resulting in higher rates could disproportionately affect this market. While the risks of macro trends always loom and can create opportunities, so to can the repricing of risks in a certain sector or specific company that can be little correlated to the overall market.

### Selective purchases and additions in last 2 months

As we touched on in our fall report, the Fulcra Credit Opportunities Fund held cash and cash proxies of 38 percent at the end of the 3rd quarter. In the later weeks of 2019 and into 2020 we



purchased a few new select positions while adding to existing ones bringing down the cash proxy weight to 27 percent and increasing the yield to maturity to 8.4 percent from 7.7 percent at the end of the 3rd quarter while keeping duration at 1.8 years.

The one sector of the High Yield bond market that did not experience double digit returns in 2019 was the energy sector. As a result, we observed a high level of indiscriminate selling of corporate bonds in this sector, regardless of quality. Fulcra owns one energy producer, NuVista, and we used this opportunity to add to the Fund's position.

NuVista is an intermediate oil and gas producer primarily focused on the condensate rich Montney formation. Condensate, a by-product of natural gas production, is approximately 30% of NuVista's production yet accounts for more than 60% of revenue. Condensate, critical to maintaining proper viscosity for the efficient movement of Canadian oil through pipelines, is generally priced at a premium to oil because Canada is a net importer of condensate from the US.

While the company's focus on the condensate market makes strategic sense, it is their ability to turn on and off their capital expenditures to grow production, based on the commodity pricing environment, that will allow it to protect its current low leverage of 2.1 times.

The Fund's most recent purchase of the only Nuvista bond outstanding (CAD \$220mln) due March 2023 was at a yield of 8.6 percent. This compares very favorably to recent bond new issues from both MEG Energy (leverage 4.5 times) and Baytex (leverage 2.2 times) with yield / maturity of 7.125 percent / February 2027 and 8.75 percent / April 2027 respectively. Given Nuvista's strong credit metrics and valuable untapped asset base, we believe that the company could utilize the bank / secured market to refinance bonds if required.

All said, with the purchases we have made over the last couple of months, the Funds accessible liquidity is still historically high at 27 percent of the Fund. As we go to press, the coronavirus is taking the steam out of risk markets. It is human nature to anchor to a historic event (i.e. SARS) to help create a narrative for present day. Unfortunately, this attitude can get investors into trouble if treated too cavalierly. Today, interest rates are lower, the stock market is trading at a higher valuation and China represents a much bigger part of the global economy. Risks that need to be treated with respect.