FULCRA
ASSET MANAGEMENT INC.

December 2022

Apollo 11

January 20, 2023

The Apollo 11 mission in 1969 was an amazing feat as Neil Armstrong became the first human being to set foot on the moon. The documentary, of the same title, used original footage to transport the viewer back to the space-race era and the captivating landing on the moon and journey back to earth.   The return part of the mission required the Lunar Module Eagle, after completing its mission to the moon's surface, to rendezvous with the Command Module Columbia in the moon's orbit.

The Apollo 11 mission was a monumental undertaking at the time and involved many risks and uncertainties that a team of individuals worked diligently to minimize and mitigate them. Cue, corny analogy…

US Federal Reserve members are as well trained and experienced in the business of central bank policy as any. Yet they have been tasked with bringing inflation back down to the 2% range from a level it hasn't -seen in nearly 40 years, while avoiding a major economic contraction. Unfortunately for the Fed, there are so many variables out of their control that make the predictability of a safe landing much more difficult.

Risk markets saw declines in December that extended losses for an exceptionally tough investment year. Even traditionally viewed safe investments, such as investment grade and government bonds, were bludgeoned by the multiple interest rate increases by the US Federal Reserve and other global Central Banks.

This time last year most investors did not seem ready to believe that interest rates were going to go higher in the quantum that they did. And, while the rise in interest rates may be closer to the end than the beginning, it does seem investors don't want to believe that they could remain at these levels.

The Dot Plot interest rate predictive tool that didn't effectively forewarn the substantial rate rises during 2022, is now predicting that interest rates will be substantially lower by the end of 2025. The median assumption is a Fed Funds rate of 3.125 percent by the end of 2025. Probably good to be sceptical.

While the Dot Plot may or may not suggest there will be a recession, a more reliable source of the economy's strength will likely play out over the coming quarters as companies report their financial performance.

Companies that have achieved record cash flow margins over the last year, may be further supported by an opening up of supply chains. However, the drop in demand that will likely result from the central bank's increasing interest rates will be very difficult to predict. It is no surprise, when listening to management teams, that 2023 will be a difficult one to call.

The recent exit from the abnormally low interest rate environment, where the demand for many goods, services and real estate was pulled forward from future consumption has the potential to impact prices significantly. The combination of lower cash flow, earnings, and higher discount rates could have a substantial negative impact on the pricing of mostly everything.

While not suggesting the outcome is deeply negative, the overall process to take the steam out will be a difficult one to thread and the case for higher volatility would appear to be strong. Furthermore, the continued conflict in Ukraine and the recent "reopening" in China make the recent reading of the VIX (the S&P 500 Index's expected volatility) at a one year low of 18.6 appear rather disconnected from reality.

While the recent enthusiasm for fixed income is warranted from a yield perspective compared to a year ago, we would be cautious on the recent rally in corporate credit. The ICE BofA US High Yield Index (H0A0) is up 3.73% and in investment grade, the ICE BofA US Corporate Index (C0A0) is up 3.97% at the time of writing.

Yes, there was likely some tax-loss selling in December in a historically bad year so one could expect a bit of a bounce back in the beginning of the year. However, due to the poor performance of the benchmarks there were very little corporate bonds issuances in 2022. Due to this lack of new supply, the coupon income generated from existing holdings gets put into the secondary market which results in bidding up the prices of these mainstream/index held bonds.

As of January 19, 2023, High Yield (H0A0) and Investment Grade (C0A0) Government OAS spreads are at 439 and 130 basis points respectively. While overall yields on the surface are attractive, we think investors need to be more tactful about their corporate bond allocations given the higher-than-normal overall earnings backdrop that naturally lags a steep rise in interest rates.

Currently, we are finding the best opportunities in shorter duration Investment Grade corporates, event driven situations, and idiosyncratic stressed high yield situations.

The Fulcra Credit Opportunities Fund as of the end of December possesses a 12.15% yield to maturity with a duration of 1.9 years.

We would encourage investors, current or prospective to reach out to get an update or learn more about our philosophy and how we avoided many of the pitfalls of the benchmark constrained fixed income world in 2022.

As always, thanks for your support.

Fulcra Asset Management Inc.