FULCRA
ASSET MANAGEMENT INC.
Phone: 604.683.8365 | Fax: 604.683.8368
Email: info@fulcraam.com

Asymptomatic

March of 2020 experienced an unparalleled market correction, in size and speed, exacerbated by challenging liquidity, technicals, large outflows and an equally unprecedented monetary and fiscal policy response by governments globally.

The market will likely now move to a new phase where fundamentals play a larger role. This is analogous to the asymptomatic cases that can spread the COVID-19 virus to the cities / countries affected. Differences between sectors and companies could be large and increasingly linked to the fundamentals, liquidity and debt profiles of companies rather than the flows of the broad market.

Outside of the 2008 Financial Crisis, the past month has been one of the most challenging and volatile in recent history, with high yield spreads widening over 600bps and hitting close to 1200bps in the final week of March. While previous credit crises mostly occurred over longer periods, this correction saw us go from all-time stock market highs mid-February to a global recession in a matter of weeks.

We see several sectors under considerable stress in the markets. There are many highly leveraged companies in the travel, lodging, retail, and energy sectors. These vulnerable industries have experienced substantial dislocation and we expect to see further economic strain going forward from these sectors.

This will affect the crossover space between BBB-rated corporate bonds and high-yield, an area that we are watching for mispricing. Given the total size of the US high yield market at $1.2 trillion, the magnitude of possible downgrades from investment grade could drastically increase the size of the high yield market.

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While $82 billion of debt from prominent names like Ford, Macy's and Kraft-Heinz were downgraded earlier this year, another USD 500billion worth of investment-grade corporate bonds are in danger of suffering the same fate in 2020. As many passive mutual fund / ETFs rebalance for the new high-yield incumbents, we expect to see considerable forced selling. One such example is a Ford Credit Canada bond due in the first week of May 2020 that we recently purchased at a yield to maturity of over 25 percent.

We have been saying for some time that **credit markets were expensive**. Currently, **the inverse has presented itself in dramatic fashion.** Year-to-date, the Fulcra mandate has outperformed the aggregate HY index marginally. The primary contributors to negative performance in the Fund have come from the following:

- **Nuvista Energy** – Natural gas / condensate producer that is sole energy producer in the Fund
- **Briggs and Stratton** – Small engine manufacturer; excess working capital and large manufacturing base
- **Rockpoint Gas Storage** – a Brookfield co. that owns AECO and other natural gas storage hubs

In periods of volatility like that experienced in March, **bonds were marked down between 10 to 25 points with little trading volume**. Despite their performance, our investment thesis for these names hasn't changed and we believe their return profile is very favourable.

A key differentiator between our mandate and the index[1] is, as of the end of March, the Fulcra mandate yielding 18%[2] compared to 9.5%[2] for the index. In our opinion, this speaks to the benefits of an active, concentrated credit strategy in times of dislocation.

Under normal credit conditions, the Fund typically pursues opportunities within the $150-500M issuance range. However, given the breadth of the sell-off **our opportunity set has expanded dramatically** as many medium to large size "franchise" like businesses with long-term staying power / financial flexibility and liquidity trade at very attractive yields.

Currently we are operating under the assumption that the Covid-19 pandemic could continue into 2021. Like all of us, we are hopeful that the pandemic is resolved quickly. While the market appears to have recovered from the initial shock and awe, there still exists many short duration liquid investments where we can generate attractive returns while maintain the flexibility to pivot to other opportunities as this uncertain period plays out.

As overall risk-off behaviour has priced corporate bonds and loans to attractive returns over the next 2 to 5 years, history would suggest this is a very good time to invest in credit. While this opportunity has presented itself in dramatic fashion in a historic context, and the path forward will continue to be uncertain, we do think the hand dealt the prudent credit investor will trump an equity investor.

Sincerely,

Matt Shandro

Fulcra Asset Management

[1] ICE BofA US HY Index
[2] Yield to Maturity. Fulcra Credit Opportunities Fund vs. ICE BofA US HY Index

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