JUNE 2022

Winding Road

Macro musings

Since the beginning of the year, the threat of higher interest rates has played out. The result has been a bond / growth stock rout for the ages, despite the US Federal Reserve only active at the turret for the last 5 months.

While equity valuations have been clipped, the fundamental adjustment happening at businesses due to higher labor, material, and financing costs, likely needs time for its full impact to be felt.

The path of where we are going is always uncertain. Obvious enough, yet the presence of the "Fed Put" (the concept that the Federal Reserve will reduce interest rates if stock prices drop dramatically) mindset over the last 13 years has possibly created a complacency that investors should now square up to.

Inflation seems to be the sole standard bearer (opposed to both full employment and inflation) for todays Fed given its historic ascendency. For sure, the investment environment has moved to a more uncertain and complicated backdrop.

Macro of micro-opportunities

Flexibility or liquidity is an important advantage Fulcra believes investors should build into their fixed income tool kit. The buy-and-hold strategy for stocks does not always apply to credit

investing given the contractual nature of bonds. That may sound counter-intuitive but just like stocks, the price of corporate bonds fluctuate frequently.

Unlike stocks, however, bonds do not "contractually" benefit from any excess profits that companies generate. As a result, paying up or continuing to own expensive, perceived "contractual" safety does not make much sense in many cases, for corporation's rated BBB[1] or below, in particular. Furthermore, many corporate bonds fund managers have inflexible investment policy mandates that limit or outright restrict their ability to invest or continue to hold a corporation's bonds.

The importance of the 'Buy' decision is an important contributor to generating differentiated performance. Instead of building a portfolio around a corporate bond index, with duration historically being a limiting characteristic, we focus on corporate bonds that we like at the right price. Prior to this year, however, the credit risk premium (or spread) was at an all-time low while government bond yields were at their near lows. In our opinion, not a great period to be fully invested in the benchmark.

Fast forward to the middle of 2022 and the universe of opportunities has expanded dramatically. While the yields of longer duration bonds have improved, **Fulcra's focus will be on the event driven nature of the secondary market**. Earnings volatility driven by inflation and supply chain challenges, (forced) technical selling, central bank policy guessing, credit rating changes, etc. will continue to expand the universe of opportunities. Over the next couple of years, the ability for many companies to adapt to this new reality will take many twists and turns.

The current twist in the market created a unique opportunity in the bonds of Seaspan Corp. Late in the 2nd quarter the Fund purchased the company's 6.5% coupon bonds due Feb 2024 at an 8.9% yield-to-maturity. As a near "investment grade" credit and the largest independent owner / lessor of container ships globally we were excited to add this position to the Fund. At the time of purchase Seaspan's pari-passu bonds due 5yrs later in 2029 were only trading with 30 to 50 basis points more yield.

[1] S&P's global ratings

As a major marketplace for the financing of the shipping sector, the Scandinavian capital market system has also issued many of these bonds in USD. However, recently the strength of the USD vs Norwegian Kroner has increased the cost of hedging for many Nordic / European Investment Funds which has only been exacerbated by the weakness in the overall credit market. The Fund was able to move on this secondary market opportunity due to available liquidity.

An event driven opportunity that the Fund had been buying through the first two quarters of the year are the bonds of KAR Auction Services, Inc. A great example of the inefficiency of markets; the recently completed sale of the ADESA US physical auction business to Carvana allows the KAR management to execute on their publicly disclosed ambition to deleverage the balance sheet. Yet the only bonds due to be taken out were trading at the end of the 2nd quarter 5 points lower than the Fund's first purchase a few months ago. In a worst-case scenario these bonds would be called at $101.281 in May of 2023 generating a 11.2% return to the Fund despite the indicated yield-to-maturity being 6.6% and 2 years longer in duration.

Looking down the twisting road, the energy and retail sectors possess some interesting opportunities. The discrepancy between the excessive free cash flow generation of some oil and gas producers and service providers and the price credit investors are willing to pay for shorter duration bonds appears wide.

Within retail, many low levered companies, both large and small and leaders in their field have swooned recently in large part due to an overall "perception" of how the increase in borrowing costs will affect consumer behavior.

Where the road goes, no one knows. Yet, undeniably, it has become a more target rich environment.