NCM Fixed Income Update

2018 Year End Review


Bill Holy, MBA, CFA
Portfolio Manager

Owen Morgan, MBA, CFA
Portfolio Manager

Cumberland Investment Counsel Inc.

Reflections on 2018 and 2019 Fixed Income Outlook

The fourth quarter (and December in particular) saw Canadian and U.S. fixed income markets give up some of the already modest gains they had accumulated through September.

- The ICE BofA Merrill Lynch US High Yield Index decreased by 2.3% in 2018, with a -2.2% return in December alone.
- On the positive side the ICE BofA Merrill Lynch Canada High Yield Index ended 2018 with a +2% return, however it decreased by 0.9% in Q4/18.
- The Credit Suisse Leveraged Loan index also generated a modest 1.1% return in 2018, but gapped downwards -2.3% in December.
- The ICE BofA Merrill Lynch US Corporate index generated a -2.3% return in 2018, while the ICE BofA Merrill Lynch Canada Corporate index eked out a 1.0% return.

Many factors weighed on the market:

- Investor concerns over Canadian and U.S. economic prospects and fears of a recession grew.
- Leading indicators of business confidence and investment declined.
- The outlooks for both countries' future interest rate paths grew cloudier, and investors feared what this might imply for fixed income assets.
- The price of crude experienced a sharp drop.
- The Bank of Canada hiked interest rates twice (in July and September),while the US was even more active, hiking four times during the year (when interest rates rise, bond prices fall).
- Political events (e.g. worsening trade dispute between the U.S. and China, Brexit, the government shutdown in the U.S. and political gridlock) were net negative for fixed income markets in general.
- Both the high yield bond and leveraged loan retail markets experienced historic cash outflows (a record $11.6B of retail outflows from loan funds in the U.S. in December, representing an estimated 9% of assets under management, and high yield bond retail mutual funds experienced $8.2B in outflows in December, bringing the total for the year to $42B). In light of the market turmoil, new issuance came to a complete standstill in December, with zero issuance in both the U.S. high yield bond and leveraged loan markets (the first time since Nov. 2008 in the case of the high yield market).

In 2018, while not immune from the factors above, the NCM Short Term Income Fund benefited from its weighting in Canadian High Yield bonds and leverage loans, which were two of the few sectors in fixed income generating positive returns. In addition, our strategy of keeping duration low during this period of rate hikes also benefited the Fund.

2019 Outlook

Nothwithstanding the challenging market in 2018, we feel optimistic looking ahead to 2019.

Fixed income markets have rallied sharply in the first few trading days of the year (beginning with the final day of 2018), recouping a large portion of the losses felt in Decmeber 2018. With that said, many names are still trading off their 52-week highs so we believe there is still room for some capital appreciation. In addition, there are several reasons to be hopeful.

But overall we feel the positives outweigh the negatives, however, and we feel more optimistic entering 2019 than we did a year ago.

Bond and Loan defaults remained scarce in 2018, and the 2% default rate is low by historical measures. More importantly, the default rate is not expected to increase materially in 2019. Default rates are a key measure high yield bond and leverage loan investors use to assess overall market health.

Overall market leverage, a key ratio for the asset class, has trended modestly downwards (lower leverage – a positive for the asset class) over the past year / year and a half. Although estimates for companies' forward earnings in 2019 have been cut, the forecast still calls for growth.

Given most forecasters predict sharply lower 2019 issuance in the high yield market, and moderately lower issuance in the leveraged loan market, these factors should be supportive for prices (limited supply).

Spreads are currently exceeding longer-term averages, in both loans and high yield bonds markets, making these asset classes more attractive for investors.

The rate hike cycle appears to nearing, or possibly at, its end. Mr. Poloz signaled no rate hike last week (leaving the overnight rate in Canada at 1.75%). The market is estimating there will be zero hikes in both the U.S. and in Canada. Most economists we follow assume a modest one or at most, two, interest rate hikes in 2019. As investors are aware, interest rate hikes cause fixed rate interest bearing securities to fall in price. If the market and the economists are correct, this should make fixed rate interest bearing securities (such as bonds) more attractive.

There remains much for the market to be concerned over, admittedly. While trade talks between the U.S. and China appear on track to reach some sort of agreement in the upcoming weeks, until a deal is signed, it represents a major risk. Unexpected negative news on the political front is just a tweet away. The yield curves in both the U.S. and Canada are extremely flat (as readers are aware, if they were to invert, it is an indicator of potential recession in the next 12-18 months).

But overall we feel the positives outweigh the negatives, however, and we feel more optimistic entering 2019 than we did a year ago.

Given the expectations above, while we will continue to maintain the fund's short duration (currently under 2), we may extend it a little (no more than 3). We will also continue to move the portfolio up in credit quality given the improvement in yields in that space and reduction in interest rate risk given our belief the rate hike cycle is at or near its horizon.