Arrow Capital Management Inc.

Experience. Active Management.

EAST COAST MARKET COMMENTARY

DECEMBER 2020

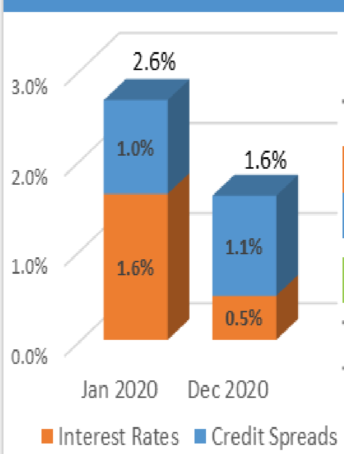
After a very tumultuous year for markets, 2020 has ended on a positive note. Risk assets rallied as worldwide rollout of multiple COVID-19 vaccines were initiated and after much fan fare, a new fiscal relief bill was finally signed. Canadian equities (S&P TSX Comp) added +1.72% in December while US equities (S&P 500) had a strong final week of trading, returning +3.84% in December. Credit spreads also rallied into year end with spreads 7-8bps tighter (rally) on both sides of the border. Unlike equity markets that closed the year higher, credit spreads closed the year small wider (weaker) with Canadian IG spreads 7bps weaker and US IG spreads 2bps weaker on the year. If we just looked at the year end equity and credit results it would seem that not much happened in 2020, despite living through COVID-19, March's liquidity crisis, and the subsequent 10mos recovery.

It is within the interest rate market that a more accurate story is told – the fear, uncertainty and volatility in 2020 was evident as 10yr interest rate yields in Canada and the US rallied (moved lower) approximately 100bps (1%). Rate curves steepened dramatically (shorter-dated maturity yields dropped more than longer-dated maturity yields) as global Central Banks, in the height of the liquidity crisis, dropped their target rates to zero and launched massive QE programs seemingly overnight. Central Banks had one goal: rescue the economy (and market).

EAST COAST'S ACTIVE CREDIT MANAGEMENT SHOULD CONTINUE TO OUTPERFORM

With rates remaining at these all-time lows and negative real returns expected across all traditional fixed income for the foreseeable future, investors will need to proactively adjust their investment mix. Inaction implies a willingness to accept next to zero returns at best and capital losses when rates rise (as witnessed thus far in 2021). At the same time, indiscriminate chasing of yields (return) likely brings unwanted portfolio risk. What investors often forget is the extremely high correlation (typically +0.70 to +0.95) of all traditional fixed income funds (universe, corporate etc.) to interest rates. The chart (below left) shows the change in Canadian IG corporate bond index all-in yield composition over the year. Interest rates rallied significantly (1.6% to 0.5%), while credit spreads were slightly weaker (1.0% to 1.1%). The interest rate portion of a corporate bond yields only 0.5% and we believe there is more risk than return opportunity remaining in rate exposure. East Coast isolates credit spreads by removing (hedging) interest rates.

Corporate Bond All-in Yield (left) and Return (right) Composition



	5yr	2016	2017	2018	2019	2020
Corporate Bond Index Return	+4.9%	+3.7%	+3.2%	+1.1%	+8.1%	+8.8%
Rates portion[1]	+2.5%	-0.2%	+0.3%	+1.5%	+3.7%	+7.2%
Credit spreads portion	+2.4%	+3.9%	+2.8%	-0.4%	+4.4%	+1.6%
vs Arrow EC (AECIAA)	+6.2%	+10.5%	+6.6%	+1.3%	+7.1%	+5.5%
AECIAA Outperformance	**+3.8%**	**+6.6%**	**+3.8%**	**+1.7%**	**+2.7%**	**+3.9%**

[1]Rate portion of FTSE Canada corporate bond index: Estimate from calculating a duration adjusted federal return of the corporate bond index (using the FTSE Canada Federal return)

Source: Bloomberg 7yr GCAN yield and LCANOAS spreads. Return table: BMO Capital Markets, East Coast

The table (above right) shows the return composition of the Canadian IG corporate bond index, broken down by the interest "rates" return portion (in orange) and "credit spreads" return portion (in blue). Interest rates have driven 50% of corporate bond returns over the last 5 yrs. It is 2020 where a large anomaly exists - interest rates produced over 80% of the total return (7.2% of the 8.8%). At current rate levels, investors must be realistic. The "rates" return portion of any traditional fund will be hard pressed to return even the 0.5% current yield over the next 3yrs as, if rates rise, there will be associated losses.

Investors should look for specialized, active managers who can drive returns from the small pockets of value remaining within fixed income, including IG corporate credit. We have tried to compare AECIAA credit returns (in green) vs the corporate bond index credit spreads portion (in blue), to get a more 'apples to apples' return comparison, as our strategy removes interest rate exposure. The majority of our credit exposure is a selective subset of bonds in the index and has typically had very similar overall portfolio duration (CS01) risk. However, the return streams have been very different. As you can see above, AECIAA has added an additional +3.8 annual return over the last 5yrs, when compared to the credit spreads return portion of a corporate bond index. This credit value-add, or Alpha, return is critical right now, as returns from interest rates will no longer be able to 'hide' the sub optimal credit returns provided by passive corporate bond funds.

MARKET SNAPSHOT

Canada		US	
Credit (Bloomberg Barclays Cdn Corporate Index)	Rallied 7bps	**Credit** (Barclays US Aggregate Credit Index)	Rallied 8bps
Equities (TSX Composite)	+1.72%	**Equities** (S&P 500)	+3.84%
Interest Rates (GoC 10yr)	Weakened 1bps	**Interest Rates** (TSY 10yr)	Weakened 7bps

CREDIT SPREADS AND INVESTMENT OUTLOOK

Many investors have asked about the level of credit spreads and what to expect from the asset class in 2021. Canadian IG credit spreads are currently 111bps (1.11%). Spreads remain weaker (wider) than early 2020 and are trading on top of their historic median 115bps (1.15%) over the past 18 years. Currently there is too much Global money chasing extremely limited yield opportunities. Most asset classes traded at all-time highs in 2020, yet credit spreads haven't even tested post-GFC tights, 88bps (0.88%), let alone pre-GFC tights, 51bps (0.51%). Conversely, we believe any spread widening will be limited and occur slowly – meaning portfolio yield and active trading should be able to offset any modest widening in 2021.

Without exposure to interest rates (which rallied 7% on the year), the East Coast strategy was still able to outperform traditional fixed income (interest rates, universe and corporate bond mandates) as well as Canadian equities. This additional "rates" return portion of traditional fixed income is off to a rocky start. Ten-year Gov't bonds (GCAN10s) have risen from 0.67% to 0.84%, which doesn't seem like much, but represents a -1.5% loss. Credit spreads, on the other hand, have rallied (tightened) to start the year. Rates are volatile and will likely rally that back, but we believe rates will not test the lows of 2020 and are much more likely to slowly rise, resulting in price depreciation (losses) over time.

If you are invested in a passive, traditional fixed income fund, your current yield (yield to maturity) is between 0.6%-1.7% on average and 1yr GICs net you around 0.2% (RBC redeemable). We have argued at length that investors should isolate credit – by removing the interest rate exposure from corporate bonds. This allows investors access to the most valuable portion of the corporate bond and serves to protect them from potential capital losses as rates eventually rise. The flexibility afforded by active mandates, such as East Coast, should be even more important in 2021.

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Thank you for your continued interest in the Fund. For further information, please contact your regional Arrow Capital Management representative.

Sincerely,

East Coast Fund Management Inc.

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