Arrow Capital
MANAGEMENT INC.

Experience. Active Management.

EAST COAST MARKET COMMENTARY

OCTOBER 2020

The market's focus in October was dominated by the resurgence of COVID-19, especially in Europe, as well as the upcoming US election. It wasn't until late month, when Europe, in a bid to stem further COVID-19 spread, officially moved from local to national restrictions, that the markets started their downward spiral, erasing any early October gains. By month end, further U.S. election uncertainty had added fuel to the fire with US equities (S&P 500) closing the month down -2.66% and Canadian equities (S&P TSX) down -3.11%. As our investors know, our team has discussed ad nauseam the increasingly positive correlation between equities and rates. Interestingly, nobody seems to notice when it's a positive return month; however, October saw interest rates sell off as well with Canadian rates (10yr GoC) weaker by 12 bps and U.S. rates (10yr TSY) a massive 19 bps weaker on the month.

CREDIT SPREAD PERFORMANCE

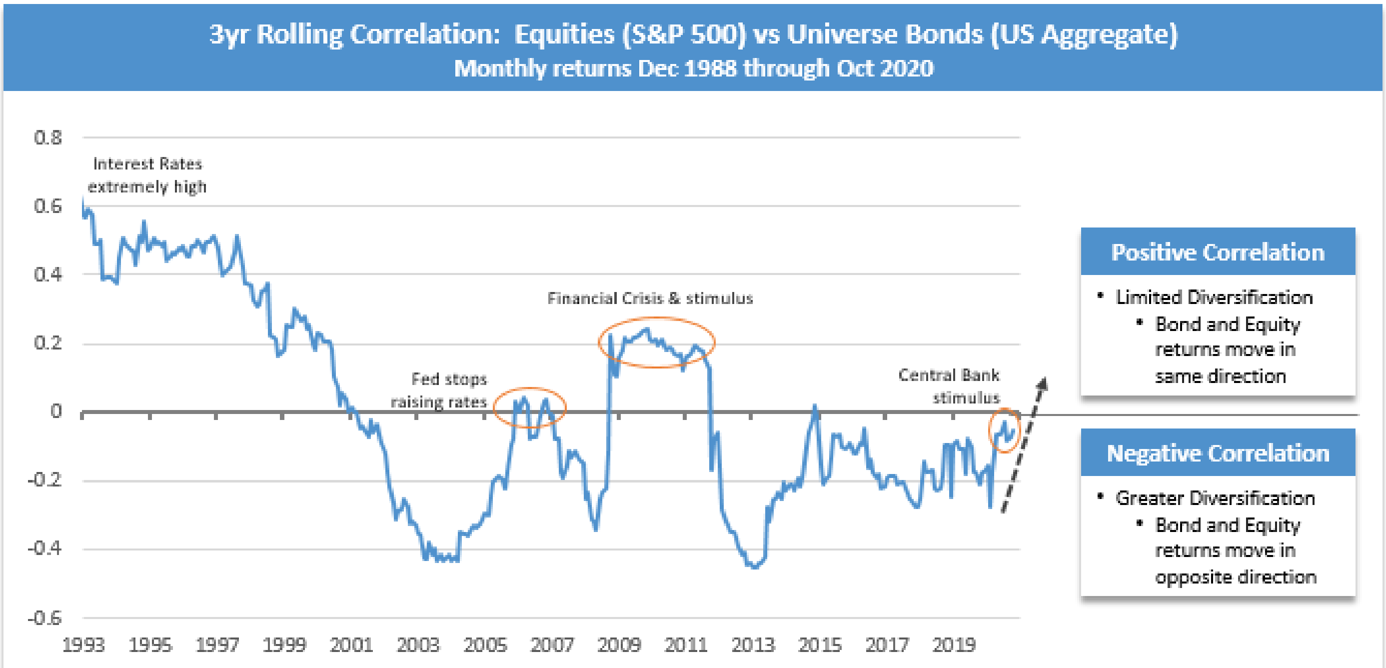
Credit spreads were a shining star in October, rallying a sizeable 9bps in the U.S. In Canada, the overall index rallied only 1 bp; however, short dated (1-5yr) credit spreads – where East Coast is over 98% positioned – rallied 5 bps on the month. The demand for cash credit was clearly evident, as the credit spread portion of our short dated Canadian corporate bonds were able to rally even with the equity risk-off headwind. The last 4-5 podcasts have highlighted the significant inflows into cash corporate bonds as well as the limited supply from new issuance. In a month where equities (risk), interest rates (risk free) and even credit derivatives all weakened, cash credit showed true resilience as investors put cash to work in corporate bonds at higher all-in yields [due to interest rate weakness].

PORTFOLIO ALLOCATION REQUIRE MORE DIVERSIFICATION

Traditional portfolio allocations, or asset mixes, are typically equity and fixed income heavy in an attempt to provide investors with diversification. This was based on the expectation of negative correlation: whereby risk-free interest rate assets (gov't bonds) would usually rally when risky assets (equities) sold off. The way to diversify a portfolio is to add negatively correlated investments to the mix. We believe October was just an early peek of what is to come – an increasingly positive correlation between traditional equity and fixed income. East Coast's strategy generated a strong positive return in October, highlighting once again negative correlation and diversification are key right now.

Since the adoption of the 60/40 portfolio in the late 80's there has been a reasonable diversification benefit delivered between the two asset classes (bonds and equities). Throughout the 90's, rates and equities were positively correlated, with bond and equity prices both rising, primarily because the absolute level of yields from bonds was so high (as much as 10% in the US and 12% in Canada). Given the extremely high level of government yields, investors were virtually guaranteed a positive return, even if rates moved higher periodically. The opposite is true now – interest rate yields are at all time lows. With less than 1% bond yields investors are virtually guaranteed to experience a minimal return even if rates move lower periodically. Additionally, the S&P 500 only had 1 year with a small negative return (and 6 years over 20%+) in the 1990s. Expected equity returns are much more uncertain today.

The chart below shows 3yr rolling monthly correlation of US equities (S&P 500) and the U.S. bond universe (U.S. Aggregate Index). In the 80s and 90s there was positive correlation for the reasons outlined above, but we believe we are headed back to positive correlation in the 2020s for the exact opposite reasons. This is problematic for investors whose portfolios are predominately invested in equities and bonds, as they have grown accustomed to negative correlation over the better part of the last two decades. The expectation that fixed income will continue to help offset equity losses appears extremely flawed given today's market environment.



MARKET SNAPSHOT

Canada		US	
Credit (Bloomberg Barclays Cdn Corporate Index)	Rallied 1bps	**Credit** (Barclays US Aggregate Credit Index)	Rallied 9bps
Equities (TSX Composite)	-3.11%	**Equities** (S&P 500)	-2.66%
Interest Rates (GoC 10yr)	Weakened 12bps	**Interest Rates** (TSY 10yr)	Weakened 19ps

INTEREST RATES/TRADITIONAL FIXED INCOME RETURNS ARE LIMITED

Interest rates and traditional fixed income derive their returns from two components – the annual yield as well as any capital gains or capital losses from movements in spreads. When yields are very high, fixed income portfolios are insulated from a selloff in rates or spreads. Below are two charts. The chart on the left shows 10yr Canadian Government (GoC) yields since the 1990s. The average over these 30yrs is 4.7%, meaning a 10yr government bond would have contributed 4.7% to your portfolio over the last 30yrs. It currently contributes around 0.6% (current yield of 10yr GoC). The chart on the right shows the movement in rates each year that would represent capital gains or losses. As our investors know, when rates (yields) have gone down, prices have gone up, or rallied. Therefore, the average change in 10yr GoC yield was -29 bps, which represents a capital gain as price went up, and equates to roughly a +2.3% annual return boost from shrinking interest rates during the year. With current 10yr GoC yield at approximately 0.6%, future capital gains are harder to imagine as interest rates would need to still go lower from here.

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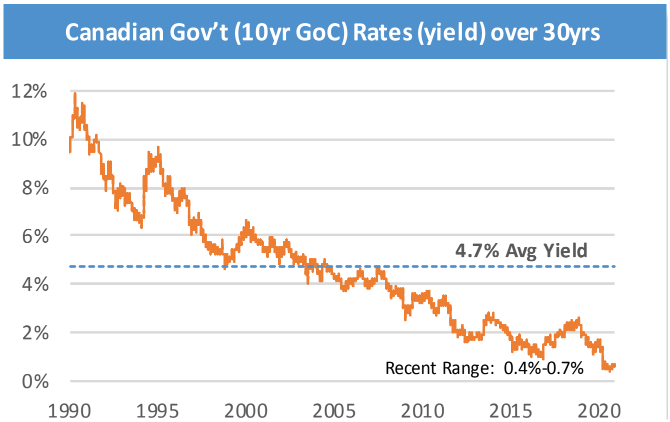

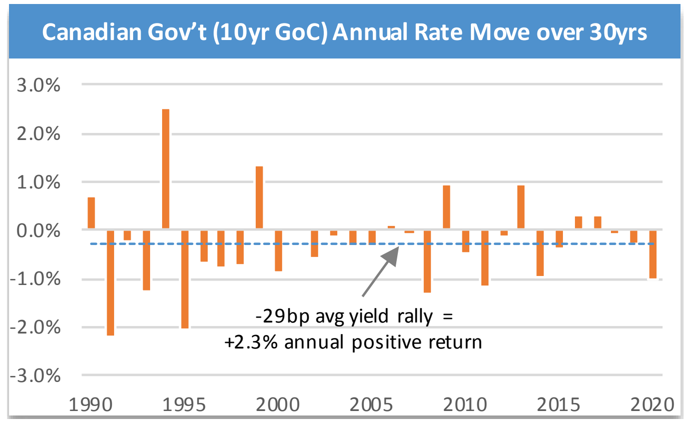

As a reminder, the return from fixed income investments is the sum of the annual yield and the positive or negative return from movements in rates and spreads. We believe, interest rates will remain around these all-time lows (highest prices) for the foreseeable future, as central banks globally continue to reinforce their commitment to low rates for longer.

What are investors to do now? We believe that there is a growing probability over time that equity and bond returns will become positively correlated in an environment where bond prices are falling (yields rising). With virtually no yield expected from rates over the foreseeable future, investors should be looking to diversify by shifting allocation weights within the portfolio and including new asset classes into the investment mix that are not correrlated to interest rates.

One way investors may 'think' they are diversifying is by including universe and corporate bond funds which invest in all bonds, not just interest rates. Unfortunately, as the table to the right shows, these funds have a very high positive correlation to interest rates. Any diversification benefit is more than overwhelmed by the interest rate component embedded within every single bond.

CORRELATIONS (since Sept 2009)	Interest Rates (Federal index)	Equites (S&P TSX)
XBB (iShares Universe Index ETF)	+0.84	+0.19
XCB (iShares Corporate Index ETF)	+0.54	+0.43
Arrow EC Income Advantage	-0.22	+0.74

This move towards positive correlation across all traditional asset classes will make portfolio diversification very difficult. Alternative investment mandates, such as East Coast, can play a key role in this diversification and be used to help 'round out' portfolio mixes. Additionally, active mandates have the flexibility to structure portfolios in a way that contributes different return outcomes than the more homogeneous streams provided within traditional portfolio allocations. If October is any indication of what the future may hold for investors, alternative strategies, such as ours, will become increasing popular.

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.

Commissions, trailing commissions, management, performance and other fees may be associated with this investment. Investors should read the offering memorandum before investing. Unless otherwise stipulated returns are for Class F shares in Canadian funds. Except as otherwise noted returns are historical compounded total returns including changes in the share value and reinvestment of all dividends or distributions and do not take into account the sales, redemption, distributions or optional charges or income tax payable by the investor that may affect the compound growth rate and are not intended to reflect the future value of the fund.) Past performance may not be repeated. Offering of units in the East Coast Investment Grade II Fund are made pursuant to the Confidential Offering Memorandum (OM) only to those investors who meet certain eligibility or minimum purchase requirements. Important information, including the fund's fundamental investment objective is contained in the OM which may be obtained from Arrow Capital Management Inc.

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