Market Commentary

MARRET ASSET MANAGEMENT INC.

CI Digital Roadshow – Summary of a presentation on income investing by
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January 22, 2014

Market overview

- The yield of the overall high-yield market is about 5.5%, which is at the low end of its range for both the past 40 years and the past few years. However, the spread is just under 400 basis points (bps), which is line with the long-term average. (The spread is the premium in yields relative to government bonds and represents high-yield investors' compensation for taking credit risk.)
- Meanwhile, the current default rate on high-yield bonds is around 1%, which is very low compared to the average of around 4% over the past 40 years. In other words, high-yield investors are getting paid 400 bps to take on about 70 bps of default risk (since defaults usually do not result in 100% losses for bondholders). This is a very favourable relationship historically and shows that the most significant risk now is not defaults but rising interest rates.
- There are three phases in the high-yield market cycle: 1) Bull market, coming out of recession when defaults and spreads are high and there is the potential for strong capital gains; 2) A neutral market, when spreads are tight and defaults are low and returns depend on yields, and 3) Recession, when defaults and spreads are rising.
- We are currently in phase 2, which we expect to last at least another 12 to 18 months. Our approach in our portfolios during this phase is to aim for market yield with less risk.

Interest rates

- We see a modest increase in interest rates this year. The 10-year U.S. Treasury yield is currently about 2.8% and we expect it to end the year at 3.25% to 3.5%. This view is predicated on the fact that, despite massive quantitative easing in the U.S. and monetary stimulus around the world, inflation has done nothing. In addition, a bigger increase in rates will only worsen the world's debt problems.
- This can be characterized as a cyclical rise in rates, not secular. The fact that the 30-year secular decline in rates is now over doesn't mean there will be a similar significant increase. Over the past 100 years, the normal range for interest rates has been 2% to 4% and it was the 1970s and 1980s that were abnormal.

Rising rates and high yield

- High-yield bonds can be a "safe haven" in times of rising interest rates because they are more correlated to equities than they are to government bonds. That's because when rates are rising, the economy is usually improving, corporate cash flow is improving and the default risk is falling – which is more important to high-yield values than rising rates.
- In fixed income, high-yield bonds are the least interest-rate sensitive and during periods of rising rates have on average produced positive returns when government bonds have been negative.

- Even though rates are rising, we expect the high-yield market to outperform the consensus forecast this year. The primary driver of defaults other than the economy is maturity dates – companies default not because they can't pay the interest but they are unable to roll over the bonds when they mature. Many companies have extended the maturity of their debt so that there are a relatively small number of issues maturing within the next three to four years. As a result, even if there is a recession, we do not expect the default rate to rise above 5-6 %, while 12-13% is normal for a recession.
- We believe high yield offers a return potential similar to equities with less downside risk because of its regular income stream.

Fund flows and floating rate funds

- Fund flows can affect returns for an asset class, and flows into U.S. high-yield funds were very strong in 2012 and more modest in 2013.
- However, a lot of money went into floating rate or leveraged loan funds with the result that valuations on floating rate securities are now stretched. We are also concerned that these markets lack liquidity and are therefore vulnerable to a reversal in fund flows. They are much less liquid than the high-yield bond market.
- We believe there will not be a significant increase in rates in the next few of years, so we don't see a benefit to being in floating rate securities, especially when valuations are stretched. We believe we can achieve the same benefits with higher returns by investing in high-yield bonds with short durations.

Outlook

- We expect more volatility in 2014 because of the Federal Reserve tapering and the fact that there has not been a 10% correction in equity markets since 2011.
- We expect a modest increase in interest rates and as long as the change is gradual and the 10-year Treasury yield remains under 3.5%, we are willing to add risk to our portfolios on a correction.
- We strongly believe a significant market risk this year is stronger-than-expected economic growth. If the U.S. growth rate jumps to 3.5% to 4%, that will upset current market expectations for modest growth and gradual "tapering" of Fed stimulus. The issue is the uncertainty over how the Fed would react to strong growth, how the bond market will react to the Fed, and whether uncertainty in the bond market will spill over into equity markets.

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New funds

- Within the next month, CI plans to launch three new income funds with Marret as the portfolio manager:
  - Marret Short Duration High Yield Fund
  - Marret High Yield Bond Fund
  - Marret Strategic Yield Fund.

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