Market Commentary
Digital Roadshow

MARRET ASSET MANAGEMENT INC.

Summary of a presentation by Marret Asset Management Inc.
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Paul Sandhu – CI Investment Grade Bond Fund overview

- I look after all the investment-grade mandates at Marret and I am responsible for the **CI Investment Grade Bond Fund**.
- This is a relatively new fund at CI with a lot of unique operating characteristics.
- It is designed to be the conservative, fixed-income component of a well-diversified portfolio and is equipped with tools to manage volatile markets.

Objective of the fund

- Provide exposure to a high-quality and diversified portfolio of investment-grade corporate bonds.
- Invests in Canadian, U.S. and European markets.
- Attractive risk-adjusted returns from:
    - Capital preservation
    - High-quality investments
    - Liquidity
    - Currency management (all foreign currency exposure is hedged back to CAD).
- The fund has the ability to invest in cross over credits:
    - 10% of the fund can be invested between BB- and investment grade.

Key differentiators – Hedging expertise and experience

- Ability to hedge interest rate risk – short government bonds and interest rate futures.
- Ability to hedge credit risk – deploy liquid credit default indices to hedge against widening credit spreads.
- Ability to hedge systemic risks – single-name credit risk hedged by shorting equities.
- Ability to go to 100% government bonds – if credit markets become distressed or extremely volatile.

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Macro outlook

- We are expecting 1-1.5% growth in Canada, 2% in U.S. and 3% globally.
- Expecting a modest rise in U.S. 10-year Treasury yields to near 2.50%.
- No interest rate changes expected in Eurozone or Canada.
- Global inflation expectations to remain tempered.
- Investment-grade corporate credit spreads to be range-bound and to provide attractive carry.
- Assuming market volatility to remain high.
- Key market risks: Chinese growth, energy/commodity prices, European elections and the U.K.'s referendum on whether to stay in or leave the European Union.
- Key credit market risks: commodity prices, recession and a spike in interest rates.
- Not forecasting a recession in 2016.
- Hedging will become more valuable.

Interest rates

- Despite the concern about interest rates increasing over the past few years, interest rates are still in a very well defined range.
- We are still in a downward sloping channel; we have yet to break out of this trend.
- Our expectations for the U.S. 10-year bond is 1.75% on the low end 2.50% on the high end.
- Rates could go a bit higher, but the hype over much larger increases is exaggerated.

Interest rates will stay lower for longer because:

- High levels of government indebtedness all over the world.
- Modest global economic growth.
- Low inflation – energy and wages.
- Abundance of unutilized industrial capacity.
- Continued quantitative easing – Europe and Japan (China and Canada could also possibly start their own).
- U.S. Federal Reserve is normalizing interest rates – not a tightening cycle, normalization is key; will likely see two hikes from the Fed in 2016.

Investment grade spreads

- Over the past year, investment-grade credit spreads have moved wider and are now above historic averages.
- The risk premium that these bonds offer is becoming more attractive. The attractiveness can be related to technical factors and/or fundamental factors.
- Technical reasons:

  - Energy spreads have grown significantly and have dragged other sectors down with it.
  - New issuance supply has been increasing, resulting in increased spreads.
  - Mergers and acquisitions activity has had a large impact on new issuance.
- Fundamental reasons:
  - Overall leverage has been increasing and credit fundamentals appear to be deteriorating.
  - But if you look closer at where the leverage is coming from it is not as worrying.
  - Leverage is coming from companies with good credit ratings and strong balance sheets (e.g. Microsoft, Google, Apple etc.).
  - Many of these companies had no debt to begin with; some have taken debt to start buying back stock or paying dividends.
- We strongly believe that leverage is stabilizing.
  1. Trend among corporate treasurers is on proper balance sheet management.
  2. Dividends and share buybacks are beginning to decline.
  3. Earnings payout ratios are beginning to flatten.

Absent a recession, investment-grade corporate credit spreads are attractive today.

Performance

- 4.12% return after fees, in 2015, and was 1.5% above the benchmark.
- Credit spreads ended the year higher and rates ended the year mixed depending on the market.
- The fund was able to generate good returns through good duration management, credit hedging, focusing on very high quality credits and taking advantage of some new issuance premiums along the way.
- Next year, after fees, a 3% return is a reasonable expectation.

Barry Allan – High-yield (HY) bonds

- It has been a volatile year for high-yield bonds.
- It has been blamed as the source for all of the world's troubles.
- Main reason is that the largest industry weighting in HY debt is in energy – energy also happens to be the most distressed industry.
- This isn't unusual or unprecedented in the HY market.
- Usually the industry that has grown to become the largest industry weighting has also lead with the most defaults.
- It was the same situation with telecom in the 1990s, real estate in the 1980s, mortgage and financial services in the last decade.

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Macro outlook

- Oil, China and the Fed are keys.
- Oil is in free fall, China is at maximum pessimism. Anyone expecting the Fed to make a mistake is likely correct, the Fed has already made mistakes.
- Average strategist forecast is for four to five rate hikes; this is way too aggressive.
- We expect one or two more at the most, maybe zero if this keeps up.
- We don't think the fear of the Fed raising rates too aggressively is valid.
- China is changing the nature of growth to consumption, away from fixed investment.
- The world is looking too negatively on China; people are focused too much on the old paradigm.
- Oil will likely stabilize in the $20 range.
- Volatility will remain very high (both positive and negative).
- Valuations of HY bonds are very attractive relative to government bonds and equity.

Spreads and defaults

- Current HY market yield is 9.5% at a 7.9% spread, current default rate at 3.38%.
- Default rates will definitely rise – typically spreads and default rates track each other very closely.
- Spreads are way ahead of default rates right now.
- Spreads are discounting a much higher rate of defaults than will occur.
- HY energy yields over 18% today, 18 months ago it yielded 5% – this is where the defaults will be concentrated.
- The market is discounting that roughly 75% of these companies are going to go bankrupt.
- We could have 50-55% go out of business, which is very high historically, but it could happen – 75% is too high.
- The lower oil goes the stronger it will bounce back, likely to the mid-$40s.
- The average cost of production is roughly $60 – you can't stay below cost of production for any prolonged period of time.
- This time the slump is not due to lack of demand but an intentional supply glut, so the recovery could be faster and stronger.
- Likelihood of the rate rising materially is very low –we are likely in a long-term 2-4% range.
- Historically when rates rise HY is the best performing fixed-income asset class.
- Debt maturities are something we watch closely because this is the primary reason companies go bankrupt – they have debt maturing and they can't roll it over, or they can't come up with the cash.
- A huge rise in general maturities is not expected in 2016 which is consistent with the view of no recession in 2016.
- Inflation remains on a downward trend.

- This is strong evidence that the Fed is not in a rate hike cycle – they are just trying to get rates away from 0.
- They are raising rates in order to have room to lower it later, not raising them because of inflation. The secular trends in bonds yields and inflation are still downward sloping.