Market Commentary
First Quarter 2018

Signature Corporate Bond Fund

Broad market performance across ratings was commensurate with credit risk (e.g. CCCs outperforming Bs; BBs outperforming BBBs, etc.) which would be expected in a spread-tightening environment. However, in the first quarter it was correlated with duration as the U.S. yield structure increased despite equity volatility. Typically, duration falls in sync with credit ratings but the first quarter was anything but typical. Cross-asset correlations and volatility spiked (i.e. portfolio diversification failed) as U.S. government bond yields moved higher. Whether it was increased T-Bill supply on larger budget deficits, front-end corporate bond selling as U.S. companies repatriated foreign profits, or increased funding costs causing leveraged carry trade unwinds, there were few places to hide. The spread on the ICE BofAML U.S. High Yield Index increased 11 basis points (to +382 basis points from +373 basis points) although the all-in yield increased 51 basis points to 6.35%.

Investment grade corporate bonds had a volatile quarter, performing just behind Government of Canada bonds as interest rates rose slightly and spreads widened a few basis points. Canadian investment grade new issuance was up 11% this year as Maple issuance has picked up greatly. Issuance is expected to remain healthy in 2018 due to strong demand and relatively low cost for companies.

The Canadian investment-grade index returned 0.28% in the quarter, just behind Canadas as spreads widened by five basis points on the back of a general sell-off in global risky assets. Investor appetite for credit remains strong. On a ratings basis, the best category was BBB across all terms due to their higher carry. Highest returning sectors over the quarter were long industrials and long financials, while the lowest returning sectors were mid-term energy and short-term financials.

Performance

From an asset-allocation perspective, the fund's weighting in loans added relative value as that asset class strengthened on the gain in three-month U.S. Libor, which climbed to 2.31% from 1.69% during the quarter. Financial fixed-floating preferreds have been a long-term trade for us as the global banks repair their balance sheets. In the first quarter, this asset class has been strongly correlated with high yield as investors have been utilizing the better liquidity in this sub-asset class to rotate into equities. This is in contrast to 2015 when high-yield bond spreads widened with economic and commodity price softness but bank preferred shares held their value. Also contributing positively was currency as the 95% of fund assets denominated in U.S. dollars were hedged to 80%, leaving approximately 25% of the fund effectively exposed to the gain in the greenback.

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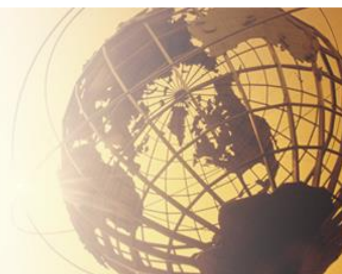

Detractors from performance

Detracting from relative performance was our position in Teck Resources 6% bonds of 2040. While the U.S. yield curve flattened significantly in the quarter, the long-end ended 23 basis points higher. This was enough to cause a price drop in long-dated corporate bonds. We view Teck Resources as a near-term upgraded candidate to investment-grade and believe the ensuing spread compression will more than mitigate any further increases in long-term rates.

Outlook

Our base case for the remainder of 2018 suggests modest spread tightening sufficient to drive positive full-year returns unless inflation data forces the U.S. Federal Reserve to a more aggressive hiking path. Falling equity market volatility would make this easier as no asset class is an island in itself. In that vein, we see high-yield bonds lacking catalysts – positive or negative. High-yield bond credit risk, valuations and sentiment are neither in the polar region nor the tropics, therefore subject to the trade winds of larger asset classes. And that is not a coincidental choice of words, as trade policy and the escalating rhetoric between the U.S. and China is a risk to growth in 2018.

The outlook for Canadian investment grade is mixed for the next quarter, as we believe the Canadian and global economies will post good growth, but the effects of higher rates will slow growth going forward. Central banks are cautiously removing excess stimulus. Corporate spreads are fairly tight so prudence is necessary. However, credit quality is expected to remain intact, demand is strong, and we do not see any signs for concern at this point. Therefore, we remain cautiously overweight corporate bonds but will likely begin to reduce our overweight position in coming months.

Class F Returns (in %) as at March 31, 2018	Year-to-date	1 year	3 year	5 year	10 year
Signature Corporate Bond Fund	0.1	2.7	3.8	4.9	6.3

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