Market Commentary
Fourth Quarter 2017

Signature Corporate Bond Fund

In late 2016, government bond yields and risky asset prices jumped higher after the Donald Trump U.S. election win. In the fourth quarter of 2017, government bond yields again turned higher on the prospects of tax reform. With a sustained global economic expansion, commodities were also stronger, yet modest wage growth kept a lid on inflation. The credit market was largely benign despite many pundits' desire to label the credit markets as "late cycle". The default rate continued to fall in the quarter and corporate credit quality improved, but more by way of earnings growth than debt reduction, a trend we believe continues in 2018. High-yield bond spreads were flat on the quarter.

Investment-grade corporate bonds bounced back in the fourth quarter and outperformed Government of Canada bonds as interest rates fell on average across the curve and credit spreads tightened. The Canadian economy performed very well during the quarter. Global risky assets were positive as the S&P 500 Index rose 6.6% and West Texas Intermediate (WTI) oil continued its march higher up 17%, to close at $60.42 per barrel. The global economy is enjoying the benefits of synchronized growth and other central banks are finally feeling confident enough to consider removing quantitative easing policies, as the U.S. Federal Reserve has done.

Credit fundamentals were stable in the fourth quarter as U.S. earnings grew and are expected to continue higher in 2018. Issuance was higher as well, which held back improvement in financial ratios. U.S. investment-grade non-financial gross debt to EBITDA remained stable in the third quarter at 3.1 times, as both earnings and debt outstanding moved higher in tandem.

The U.S. Federal Reserve raised rates 25 basis points, as expected in December, making it the third increase in 2017. The Fed's dot plot remained unchanged with another three increases planned in 2018. The Bank of Canada left overnight rates steady at 1.00% during the fourth quarter. The Canadian bond market flattened quite a bit in the quarter as a stronger economy pushed up expectations of higher overnight rates while inflation remained in check, so long-term rates actually fell 21 basis points in the quarter. The combination of curve flattening and spread tightening led to a significant outperformance of long-term corporate bonds.

Canadian investment-grade new issuance was up 17% this year as Maple issuance has picked up greatly. In the fourth quarter, issuance remained very strong, up 20% from the same quarter last year. Issuance is expected to remain healthy in 2018 due to strong demand and relatively low cost for companies.

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The Canadian investment grade index returned 1.82% in the fourth quarter as spreads tightened on the back of strong demand after being relatively flat in the third quarter. Investor appetite for credit remains very strong as most managers are using an overweight position as their main value-add driver. Sectors with longer duration such as utilities and infrastructure outperformed while short duration sectors like securitization, auto finance and real estate underperformed. On a ratings basis the best category was A due to its longer duration in the corporate index. BBB corporate bonds also did very well as spreads tightened.

Our forecast for 2018 sees further spread tightening from both investment-grade and high-yield bonds, supported by synchronized global growth, cautious central banks, and a declining default rate despite pockets of weakness in retail, generic pharmaceuticals, and wireline telecommunications. This spread compression should be sufficient to drive positive returns despite three to four rate hikes expected from the U.S. Federal Reserve in 2018. There are wildcards, like Fed policy under the new leadership of Jerome Powell, the future of the European Central Bank's stimulus program, record low volatility across asset classes, groupthink and complacency, and headwinds, principally valuations.

Current spreads (and prices) are on the expensive side of historical averages but not irrational. U.S. tax reform should turn out to be credit positive as lower corporate tax rates boost cash flows. This will be partially offset by increased expenses on the elimination of interest deductibility, but the net effect raises the after-tax cost of debt. Higher after-tax cost of debt should lead to some deleveraging, especially since borrowers' cost of equity has decreased with stocks at or near record highs. Foreign profit repatriation is also a slight credit positive, although there seem to be more beneficiaries in large-cap technology and pharmaceutical investment-grade names than in high yield and proceeds are probably directed to share repurchases and mergers and acquisitions rather than debt reduction. All told, what companies do with this largesse will determine the trajectory of credit markets in later years.

The outlook for Canadian investment grade remains positive for the first half of 2018, as we believe the Canadian and global economies will post solid growth. Central banks are cautiously removing excess stimulus. Corporate spreads are at their tightest level since the global financial crisis so prudence is necessary. However, credit quality is expected to remain intact, demand is strong, and we don't see any signs for concern at this point. Therefore, we remain cautiously overweight corporate bonds.

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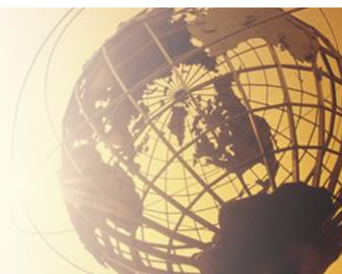

Class F Returns (in %) as at December 31, 2017	Year-to-date	1 year	3 year	5 year	10 year
Signature Corporate Bond Fund	5.1	5.1	5.2	5.3	6.4

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