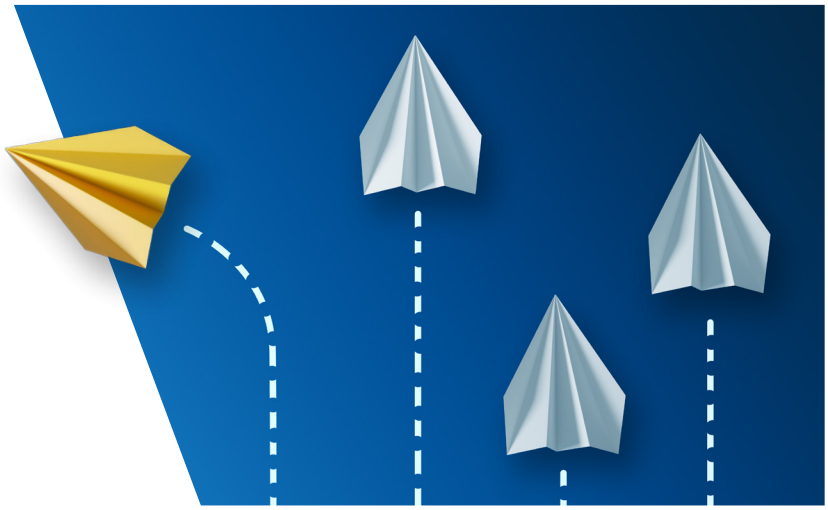
FIERA CAPITAL

DECEMBER 2020

This time, it's different

Moving into 2021 as a mindful bond investor



> The eye sees all, but the mind shows us what we want to see. – William Shakespeare

2020 has been an eventful year to say the least, with the COVID-19 pandemic dragging the global economy into its deepest recession since the Great Depression and impacting virtually all sectors of activity. Although bonds delivered great performance and diversification over the year amid significant monetary easing, fixed income markets have had their fair share of obstacles (read Challenged Liquidity: Bond Pricing in Stressed Markets). One very important lesson from 2020 to keep in mind as we move into 2021 is that markets can change rapidly and investors can unconsciously fall into the trap of the Confirmation Bias – a mental mistake that can be very detrimental to longterm portfolio returns.

Confirmation Bias:
Investors tend to become overconfident in their positioning as they keep getting and interpreting data in a way that confirms their decisions. This overconfidence increases the risk of being blindsided by market events.

The path for bond markets in 2021 seems clearly visible at first, with most portfolio managers and economists (including ourselves) arguing that rates will stay low and range-bound while credit markets will remain well-supported thanks to the stimulus put in place by central banks and governments. However, as we're only at the early stage of an unprecedented economic recovery and with investors lining up on the same side of the trade, it will be critical to seek concrete evidence that would give us an idea of how the economy is truly doing, allowing us to adjust our positioning accordingly, rather than following the herd.

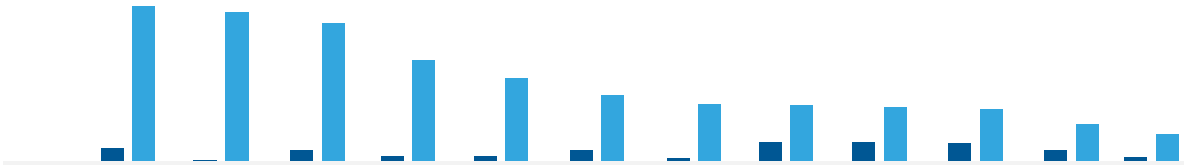
Increased stability requires increased vigilance

This crisis is most likely far from over and we will almost certainly see additional bouts of volatility, but the main reason many investors tend to agree on the general direction of fixed income markets in 2021 (i.e. relatively stable rates and credit spreads) is because of the massive response from governments and central banks to tackle the COVID-19 pandemic. This has significant impacts on the economy and financial markets as key rates are not expected to be raised anytime soon while the market expects additional stimulus should the situation deteriorate.

The COVID-19 crisis is certainly being taken seriously, with governments and central banks using all the tools at their disposal to help their respective economies navigate this extremely difficult period – measures that have also resulted in healthier and more stable financial markets. Globally, fiscal responses (such as temporary tax cuts, loans, and capital injections) have amounted to $11.7 trillion or close to 12% of global GDP[1], while central banks have cut interest rates to historic lows and committed trillions in monetary stimulus, including targeted quantitative easing programs to support less-liquid segments of the debt market. As a percentage of GDP, this coordinated global fiscal response has far exceeded the measures launched during the Global Financial Crisis of 2008.

1 Fiscal Monitor, Policies for the Recovery, IMF, October 2020. As of September 11, 2020.

Fiscal responses to COVID-19 outsize those to the Global Financial Crisis (% of GDP)



	Germany	Italy	Japan	U.K.	France	Canada	Brazil	U.S.	Korea	Australia	South Africa	India
2008	3.5%	0.3%	2.8%	1.5%	1.4%	2.8%	0.6%	4.9%	4.7%	4.5%	2.9%	1.2%
2020	39.2%	37.9%	35.0%	25.7%	21.0%	16.7%	14.6%	14.2%	13.8%	13.5%	9.5%	7.0%

Source: Fiera Capital, data via Global Economic Policies and Prospects, March 2009, IMF, and Fiscal Monitor, Policies for the Recovery, IMF, October 2020. As of September 11, 2020; relative to 2007 GDP baseline for 2008 percentage figures; relative to 2019 GDP baseline for 2020 percentage figures.

We will never complain about stability in financial markets, but will certainly remain cautious as fiscal and monetary actions make it more difficult to draw conclusions from market movements, since we're forced to sort through the noise to get the correct signals. For example, are corporate spreads tightening because of an actual improvement of the economy or simply because of a government securities purchase program? Moreover, will we see unjustified momentum in some lower-quality sectors because of increased demand from investors seeking higher yields in this extremely low rate environment? Thus, for market participants, and indeed for our team (which has an overweight in credit), it will be crucial to assess whether we're rewarded for the right reasons (i.e. thanks to factors such as improved economic and credit fundamentals), rather than letting the Confirmation Bias cloud our judgement.

Don't be fooled twice

Investment biases are as old as the infamous Tulip Mania of 1637 – considered to be the first financial bubble – but after years of a bull market, coupled with steadily decreasing interest rates and low volatility, we believe these biases have become more dangerous to bond investors than ever. As such, considering them as we position our portfolios for 2021 will be particularly important.

The events of 2020 are a good example of how turning around a bond portfolio is no easy tasks and that these investment biases can significantly hurt relative performance. Before the pandemic, investors' hunger for yield was clear, with corporate spreads reaching multi-year tights and more capital going further up the yield curve. While one could be forgiven for becoming complacent about their portfolio positioning (as investors had been making money for a long time with an overweight in long-term bonds and credit), we believe this is a classic form of Confirmation Bias. In our opinion, many investors refused to acknowledge the fact those two trades were offering, at the beginning of the year, only little compensation for the risk taken. Corporate balance sheets were getting weaker amid increased leverage and share buyback activities while there were no rolldown benefits anymore as the yield curve was even inverted. Despite this, the demand for those bond issues remained surprisingly strong. Then, when COVID-19 rattled financial markets, corporate spreads widened to levels not seen since the Global Financial Crisis while the yield curve significantly steepened, both substantially detracting value for those who had let their guard down.

Corporate spreads and the spread between 30-year and 2-year yields

Source: Bloomberg, as of October 31, 2020.

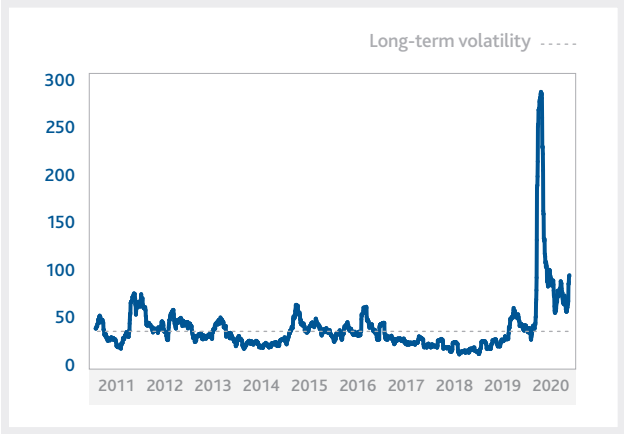
In uncharted territory

As a general rule, recessions are caused by financial market events such as inflation and spiking commodity prices, and there are normally time-tested ways to spur an effective and steady economic recovery, namely easy monetary and fiscal policies. But this time it's different, as the financial market destruction is caused by an exogenous variable – a global health crisis. From a bond manager's standpoint, this unusual economic cycle means that the patterns we normally observe during recoveries – the ones on which investors can capitalize – will likely be few and far between in 2021. For example, BBB-rated issues tend to outperform coming off of a recession, with somewhat uniform performance across all sectors as overall risk-on sentiment gradually resurfaces.

However, with the S&P 500 having returned more than 60% from its March lows[2], it's hard to argue that investors' risk appetite hasn't already been restored. Similarly, credit products have already sharply rebounded, and we can see in the chart below that BBB spreads have already returned to near their pre-crisis levels. Some BBB issues are even trading with significantly tighter spreads than before the pandemic. For instance, Brookfield Renewable Energy's bonds maturing in 2027 were trading about 130 basis points over Canadian government bonds before the pandemic; as of the time of this writing, they are now trading at a spread of about 115 basis points, despite a deterioration in Brookfield's financials[3]. Moreover, COVID-19 will most likely leave a larger scar on sectors such as leisure, airlines, and retail, which will lead to uneven performance across companies and sectors in the upcoming quarters. This has increased the value of bottom-up analysis for bond managers in a world where "business as usual" doesn't exist anymore.

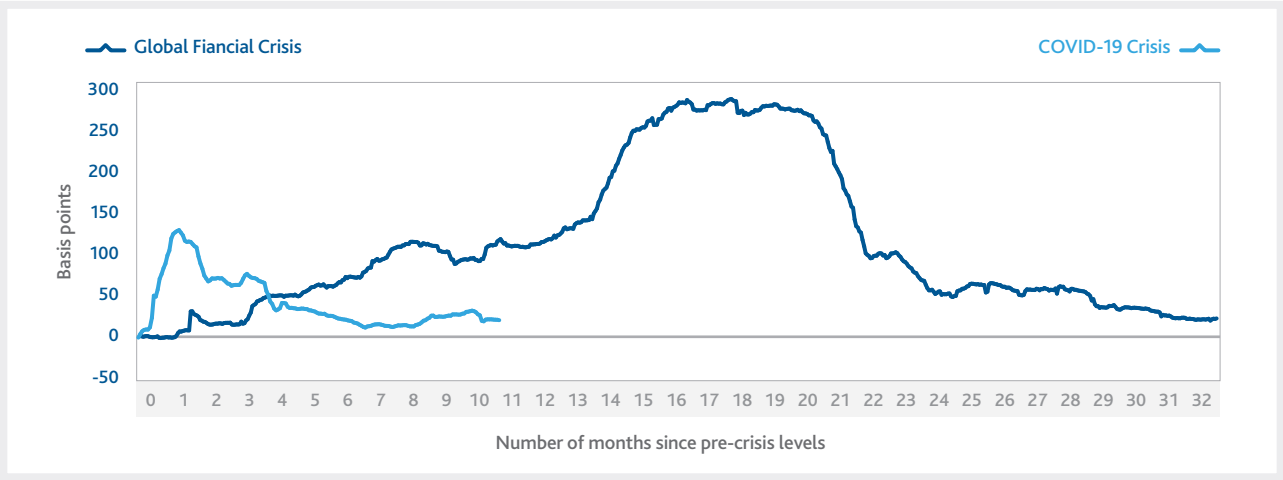
Up to now, we've focused on corporate bonds, as we expect this market segment to be challenging but also a potential source of alpha in 2021, if managed astutely. That said, even though both the Federal Reserve and the Bank of Canada have said that it will be years before they hike rates, it doesn't mean that one should overlook the direction of rates. As we can see in the chart below, yield volatility has, in fact, remained extremely high after Q1 2020 – yields are still much more volatile than during the European debt crisis of 2011 or than during the peak of the trade war between the United States and China in 2019 – allowing active managers to take advantage of the situation. Thus, while most market participants argue that government rates will stay range-bound for some time, we are of the view that duration management will still be key in 2021.

U.S. 10-year treasury rates
Rolling 30-day volatility



Source: Bloomberg as of November 12, 2020.

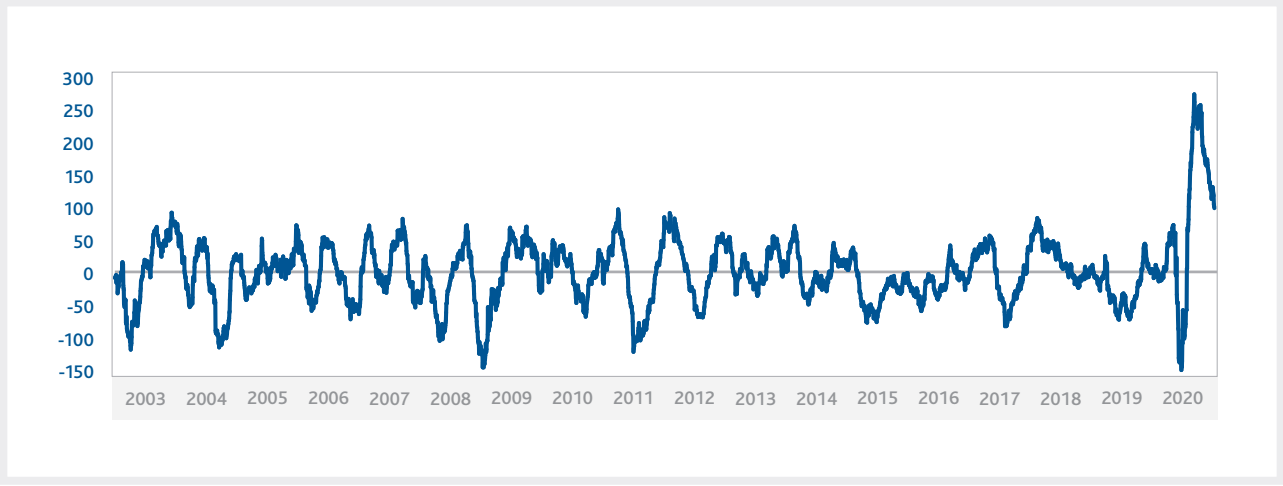
Variation of BBB spreads



Source: Fiera Capital; Long-term bonds; Spreads over Canadian government bonds; PC Bond as of November 23, 2020. We used August 9, 2007 (the day BNP Paribas announced that it was ceasing activity in three hedge funds that specialised in US mortgage debt) as the beginning of the Global Financial Crisis, and February 26, 2020 (the day new cases outside China outnumbered new cases in China for the first time) as the beginning of the COVID-19 crisis.

2 As of November 30, 2020.
3 For example, Brookfield Renewable Energy's Net Debt to EBITDA ratio increased 82% year-over-year in Q3 2020.

Citi Economic Surprise Index



Source: Bloomberg, as of October 31, 2020.

One of the reasons behind this volatility may be the fact that investors have been giving too much importance to economic indicators. Financial markets are all about expectations, and as a general rule, the market prices in analyst and economist consensuses ahead of their releases. When the actual data miss or beat those expectations by significant amounts, it prompts a re-pricing of risk. In the chart above, we plotted the Citi Economic Surprise Index, which demonstrates the degree to which actual economic data differs from the Wall Street's forecasts. We can see the index reached record levels this year on both the upside and the downside, suggesting that economic data are coming in more distant (both above and below) from consensus more than ever before. Certainly, these surprises have helped fuel interest rate volatility of late.

To be clear, when the economy runs near potential, economic data such as retail sales, PMIs, and housing starts are crucial in determining trends in interest rates. But in this never-before-seen environment, can they be trusted? Our view is that the economy is operating significantly below capacity that an improvement of, 20% month-over-month in retail sales (which was the figure we saw in Canada during May and June) won't be sufficient enough to close the output gap – i.e. the difference between the actual output of the economy and its potential – and affect rate movements. Thus, we're still monitoring and incorporating these economic data into our analysis. However, these days it is taken with a big grain of salt, as we are in unique and peculiar times. We have been forced to adapt our management style and seek additional data to find the best investment opportunities.

Bottom line:
Different times call for different measures

The word "unprecedented" is one of the most common descriptions of 2020 and we believe 2021 will be no different. The COVID-19 pandemic triggered a first-of-a-kind economic cycle that was indeed challenging during the drawdown, but that will, yet again, test investors' discipline and investment processes during the recovery. We are currently working with a base-case scenario consisting of: credit products being well-supported despite some segments having become expensive; rates staying range-bound for some time, likely to tilt towards the upside more than downside; and the yield curve to continue to mildly steepen over the next 12 months as inflation expectations rise. However, the key for our success in 2021 won't necessarily be only contingent upon whether this scenario materializes or not. Rather our success will be tied also to our ability to extract the pertinent information from market events and to react to and take advantage of the rapidly-evolving situation surrounding the pandemic.

Jean-Guy Mérette
Vice President and Portfolio Manager
Active and Strategic Fixed Income Team,
Fiera Capital Corporation

FIERA CAPITAL

fiera.com