TSX EARN

MONTHLY COMMENTARY

Evolve Active Global Fixed Income Fund

EARN seeks to generate positive returns throughout the interest rate and economic cycles, firstly by allocating to different credit asset classes, and also through bottom-up individual security selection.

For the month ending December 31, 2019

ETF TICKER: EARN (Hedged)
MUTUAL FUND FUNDSERV CODE: EVF130 (Class F); EVF131 (Class A)

Allianz Global Investors

SUB-ADVISOR: Allianz Global Investors (AllianzGI)

AllianzGI is one of the world's leading active investment managers, managing USD 601 billion in assets, including over USD 200 billion in global fixed income (as at March 31, 2019).

MARKET & PORTFOLIO UPDATE:

Global credit had a reasonable December with investment grade returning 10bp in GBP hedged terms, with a 10bp in spread tightening being offset by a sell-off in treasuries. After eleven months of caution, there was a risk grab and flowing with the tide of improving sentiment, performance increased with the riskiness of the segment: Investment grade corporates tightened by 10bps, while global high yield tightened 38bps, with CCCs rallying strongly. Yield curves steepened in both the US and Europe, with central banks keeping rates on hold but 10y US treasuries selling off 14bps and 10y bunds widening by 18bps. Having sold off sharply at the end of November, oil prices recovered strongly into year-end, with WTI Crude topping $61/bbl.

In this context, the Fund produced a strong positive return in December as carry and spread tightening more than offset the impact of rising rates. All the credit segments performed positively, with financials leading the way, followed closely by high yield. Our energy-related names were notable contributors on the rising oil price. Our equity index hedge position detracted as stock markets rallied into year-end.

During the month we did some individual issuer tidying within financials and put some cash to work buying new names in capital goods, consumer cyclicals and a utility. We kept the portfolio duration at 2.84 years.

OUTLOOK:

Looking at 2020 from a top down perspective, we expect a weaker but so far still supportive outlook for global credit, translating into a moderate increase in defaults. The performance of credit asset classes will be driven by low rates and the strength of the consumers offset by slowing (but adequate) economic growth, deteriorating profitability and high debt in some sectors as well as political uncertainties, particularly around the impact of growing trade protectionism.

A key risk to this core investment theme would come if the easing in financial conditions globally in 2019 fails to translate into an improvement in the global growth/inflation outlook in 2020.

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We are more cautious on investment grade corporate earnings growth for 2020 relative to market expectations, given subdued global growth and persistently higher input costs. Furthermore, we view current fundamentals as relatively weak with very elevated corporate debt, which we believe the low risk premium is not accurately reflecting as central banks are so far able to anchor volatility. However, monetary policy has its limits and we expect this to eventually result in rising volatility and dispersion. Our positioning reflects our concerns, but in the absence of a near term catalyst we continue to take advantage of the prevailing market conditions by focusing on themes with structural tailwinds. Most notably, 2019 ushered in a new ESG paradigm where we seek to identify companies that are active in addressing their ESG interests.

In high yield, while we expect defaults to increase in number, these should largely be in smaller and lower-rated companies. Our default rate expectation for the BB/B universe (where the portfolio is focused) is 0.4%, which is still low by historic standards. Combining this with the prevailing market spreads of 303bps, a 35 cent recovery rate and a 275bp asset class premium, the market looks fairly valued.

Given our base outlook and a broadly stable rates environment, we believe that credit returns are likely to be lower than index yield before any alpha. However, alpha opportunities should increase, particularly for those managers afforded a global and benchmark-agnostic brief, as sector and individual company performance should diverge further.