NEO FIXD

Q4 COMMENTARY

Evolve Active Core Fixed Income ETF

FIXD invests primarily in domestic and international high quality fixed income securities, and to a lesser extent, adding yield or enhancing returns on the portfolio by opportunistically investing in international fixed income securities, emerging market debt, preferred shares, convertible bonds and non-investment grade bonds.

For the quarter ending December 31, 2018

TICKER: FIXD

SUB-ADVISOR: Foyston, Gordon & Payne, Inc.

Foyston, Gordon & Payne Inc.
Investment Counsel

Fixed income allocations remain a core component of many investor portfolios as a source of income and portfolio diversification. Foyston, Gordon & Payne Inc. has managed the FGP Core Plus Bond Fund since December 31, 2015.

THE BOND MARKET AND THE ECONOMY:

Volatility in financial markets around the world returned in the fourth quarter. The combined weight of central bank interest rate increases, quantitative tightening, global trade tensions, a wave of geopolitical concerns (Brexit, Italy currently) as well as a collapse in oil prices all worked to alter the perception of the global economy as we head into 2019. This despite the relative economic strength currently seen in the U.S. and in Canada to a lesser extent. Both the U.S. Federal Reserve Bank as well as the Bank of Canada increased policy rates by 25 basis points in the final quarter of the year but, seemingly in reaction to the downturn in financial markets, have each downgraded their outlooks for the coming year as well as lowering expectations for the continuation of their respective tightening cycles.

Given the openness of our economy, Canada has been negatively impacted by the trade tensions and weak oil prices. Heading into the new year, growth should be weighed down by the impacts of a further slowing in the number of housing transactions, the overhang of consumer debt, oil production cuts in Alberta as well as slower U.S. spending. The latest reading on inflation, from November, came in at an 18-month low of 1.7% although the core measures remain around the Bank's target of 2%. Continued restraint in wage growth also implies that there remains some slack in the economy. That being said, growth in 2018 was about 2% and shouldn't be much lower than that in 2019. Indeed, with more certainty on the North American trade front and an expectation of some stimulative fiscal policy measures leading up to the October federal election growth may not be quite as gloomy as the market is now forecasting.

In response to weakness in equity markets and the heightened uncertainty and volatility, yields across the curve fell in in both Canada and the U.S. throughout the quarter. Short-end yields fell at roughly the same pace as long-end yields, thus there was little change in the shape of the full yield curve. The curve remains positively sloped, but only marginally so with about 25 basis points of yield separating two-year and thirty-year maturities.

PERFORMANCE AND PORTFOLIO STRATEGY:

The primary factors responsible for performance this quarter were related to both the short duration position, credit positioning in the fund – specifically an overweight to preferred shares, an underweight in provincial bonds, and defensive positioning in corporate bonds as credit spreads weakened throughout the quarter. Our corporate bonds notably outperformed the corporate bond index given the high quality nature of the holdings.

With the duration of the portfolio positioned at a full year below that of the benchmark this did act as a restraint on performance. The benchmark 10 year Government of Canada bond yield fell by approximately 40 basis points in the fourth quarter and, in a small trend reversal, the 2 year to 30 year yield spread widened by almost 10 basis points. Beginning at the end of October, preferred shares yielded to the widening risk-off sentiment in the Canadian and global markets and saw persistent losses throughout the quarter. This weakness was significant and has been driven by contagion from equities with added impacts from increased selling activity by the retail segment of the pref market as well as an eventual decline in interest rates (and rate expectations) mentioned above. The activity from retail investors was skewed towards holdings that were materially down on the year implying much of it was related to tax-loss selling. A benefit of this translated into dramatically different performance from similar prefs which has set up opportunities that should add value in the future.

Overall portfolio strategy saw modest changes from the previous quarter. The portfolio's duration position has been maintained at one year below that of the benchmark. With long-term federal government bond yields very near to the level of domestic core inflation, there remains little reason to be reaching for the marginal amount of additional yield that a long bond provides. With the yield spread between two-year bonds and 30-year bonds at only about 25 basis points, investors are still not being sufficiently compensated for the additional risk of investing in long term bonds. Additionally, the economies of North America are still performing adequately, even though the outlook for 2019 has become more muddled. The 10 year bond yield has fallen back to the level where we began the year and expectations for a continuation of the rate hike cycles in both Canada and the U.S. have almost been fully priced out of the market. With any resolution to the mostly geo-political issues that the economy faces we would expect interest rates to head higher once again.

With the recent underperformance of both corporate and provincial bonds, we have increased the overall weight of corporate bonds and began a shift to assume more risk to take advantage of wider spreads. We are presently analyzing the market for opportunities to continue to gradually and selectively add these investments.

OUTLOOK:

Over the short-term we expect that the preferred share market will continue to be influenced by the sentiment in the equity markets but that overall the preferred share market became exceptionally attractive by the end of December. Additionally, there has been an increasing dislocation between bonds and prefs which has been exacerbated over the last few weeks and preferred shares are now a great relative value trade. Going forward we are positive on the economic outlook for North America which, combined with the improving trade picture and strong North American employment data from December (and Q4), should move markets higher in the coming months. This should allow for rates to begin to move higher again and bolster the preferred share market in Canada. Eventually, the move to higher rates (current rates are much higher than recent years) will be reflected in higher preferred share dividends that should provide the opportunity for capital appreciation in addition to the currently outsized dividends being paid.