MONTHLY COMMENTARY

NEO FIXD

Evolve Active Core Fixed Income Fund

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 month ending May 31, 2019

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.

OVERVIEW:

What a difference a month makes. After reaching record highs in early May global stock markets fell back over the balance of the month. This was the first drop in equity prices this year and was of a similar magnitude to the declines seen in October and December of last year. The TSX, while still down, did fare better than most developed markets despite being weighed down by lacklustre Q2 bank earnings as well as a drop in crude oil prices late in the month. A rapid deterioration in trade talks with the Chinese and an end-of-the-month threat to impose a 5% tariff on all Mexican imports to the United States on June 10th (rising to 25% by October) sent a chill through financial markets.

Even as the North American economies continue to perform reasonably well, expectations for continued growth into next year are being reduced. This is clearly reflected in the performance of the bond market which saw yields come crashing down. Almost the entire Treasury curve has now seen yields drop by 100 basis points or more from their peaks of little more than six months ago. Central banks in North America have tried to stabilize expectations by reiterating that policy rates are still accommodative and supportive of growth and that there is no need to cut rates based on fundamentals. However, the central bankers are concerned about the eventual impact on the economy if the trade war deepens or persists for the remainder of the year. The market is priced for two Fed rate cuts by year-end. With a lower overnight rate compared to the Fed and with an inflation rate that is running above it, expectations for the Bank of Canada to cut rates is less dramatic – a bit more than a 50/50 proposition for one cut by the end of the year. The benchmark five-year Government of Canada bond yield fell by almost 20 basis points in May, ending the month at 1.37%.

Corporate credit performed well for most of the month, however, spreads reacted violently to a surprise escalation in the trade negotiations in North America just prior to the month's end. However, Provincials performed well as the sector benefited from its long duration in a declining rate month.

We are beginning to selectively add credit again as it looks more attractive on a risk-adjusted basis after the widening later in the month. This has included purchases of additional subordinated bank debt and new issuances of bail-in deposit notes.

The preferred share market experienced renewed pessimism to finish the month as the credit environment weakened and concerns grew over the trade war eventually having a notable impact on growth. That said, the pref market is at historically low levels and currently offers yields and spreads that are exceptionally wide versus other income producing assets.

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We anticipate that pref yields are now at such relatively aggressive levels that in the coming months the market will gradually recognize the high dividend levels of preferred shares (even in the absence of moves higher in key interest rates). When viewed with a longer-term investment time horizon we remain quite comfortable with our underlying investments in the fund as well as with an increased allocation to the fund itself as the asset class is attractively valued and offers a significant yield advantage over other fixed income options available in the market today.

With the duration of the portfolio more than one year below that of the benchmark the declining interest rate environment was negative for performance. The benchmark 5-year Government of Canada bond yield finished May down 20 basis points unchanged while the 30-year fell slightly more.

OUTLOOK AND PORTFOLIO STRATEGY:

Overall portfolio strategy was little changed throughout the month. The Fund continues to hold increased allocations to both corporate bonds and preferred shares compared to 2018. Additionally, the Fund currently has minimal exposure to high yield bonds. While the domestic economy has moderated from the highs in previous years, we continue to expect to see growth in the near term which should work to support risk assets going forward. Further, we remain confident in the credit quality of the individual investments we have made in each of these asset classes. Portfolio duration remains below the benchmark's duration as FGP continues to have an unfavorable long-term view of the bond market's risk/reward characteristics. FGP continues to believe that interest rates remain at a level inconsistent with Canada's economic fundamentals. The portfolio is positioned to perform well against its benchmark in a stable to rising rate environment.