MAY 2022

MONTHLY UPDATE

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.

TSX EARN

ETF TICKER: EARN
MUTUAL FUND FUNDSERV CODES: EVF130 (CLASS F); EVF131 (CLASS A)
SUB-ADVISOR: ALLIANZ GLOBAL INVESTORS (ALLIANZGI)

AllianzGI is one of the world's leading active investment managers, managing over USD 703 billion in assets, including over USD 239 billion in global fixed income (as at December 31, 2021).

Credit markets had mixed fortunes in May as spreads leaked wider, particularly in emerging markets and lower-rated credits. Offsetting this was a partial retracement in government bond yields as softening economic data suggested that fewer rate hikes might be needed than previously feared, even though inflation numbers continued at multi-decade highs. Oil prices resumed their upward trend, climbing from $105/barrel to $115.

As expected, the US Federal Reserve hiked rates by 50bps (to 1%) and indicated that it will start its quantitative tightening programme from June. Ahead of another higher-than-expected US CPI inflation print, 10-year US Treasury yields briefly touched their highest levels since late 2018, before reversing course to close the month at 2.85%. In the Euro area, a worsening growth-inflation trade-off continued to push the European Central Bank towards front-loading policy normalisation, with expectations that it will begin its hiking cycle in July. 10-year German yields ended the month at 1.12% - their highest levels since 2014. The Bund move was accompanied by a widening in Euro sovereign peripheral spreads, as concerns over debt sustainability are remerging in the Euro area. In the UK, the Bank of England hiked rates by 25bp to 1%, but unlike the Fed, the BOE tilted towards signalling a more cautious hiking cycle ahead given growing downside risks for the UK economy.

In this context the portfolio was down slightly in CAD terms, in line with investment grade corporates which were down a couple of basis points and ahead of global high yield which was down moderately. The fund remains substantially ahead of both on a year-to-date basis. The modest interest rate exposure and conservative credit stance were both helpful in a volatile month for risk assets. By sector, our holdings in energy and consumer non-cyclical were notably beneficial.

Portfolio strategy and activity

During the month we added in financials and healthcare. We reduced in autos and mining.

The geopolitical and supply-side implications of Russia's invasion of Ukraine have exacerbated the downside risks to global growth through the remainder of 2022. As recession risks grow, we expect some moderation in global inflationary pressures in H2 2022 and into 2023, even though inflation is likely to remain elevated in the near term given ongoing supply/demand imbalances and elevated commodity prices. At the current juncture, G10 central banks are still biased to maintain a hawkish policy stance in the face of historically high inflation prints. However, we think we are at an inflection point for growth and inflation dynamics. While G10 central banks may not yet be ready to pivot away from their hawkish policy stance, we think that as the downside growth risks gather pace, bond markets are likely to begin re-assessing the extent of rate hikes in this cycle.

Earnings season showed there are clearly greater margin pressures than expected, however, we still saw 76% of companies in the S&P report positive earnings surprises. The outlook is mixed; while analysts have increased their overall 2023 earnings forecasts, this is very much driven by a few sectors which are benefitting from higher commodity prices. Consumers face a strong headwind from high and rising energy and foodstuff costs.

In terms of valuations, global investment grade spreads are back to levels in line with long term averages and European spreads are now approaching levels seen in recessionary/risk-off periods, thereby offering a more balanced return profile. High yield looks fair only if market volatility can revert to more moderate levels; as such we have been moving the portfolio credit profile up in quality.

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Scotia Plaza, 40 King Street West, Suite 3404, Toronto ON M5H3Y2
416.214.4884 | 1.844.370.4884 | www.evolveetfs.com