Experience. Active Management.

EAST COAST MARKET COMMENTARY

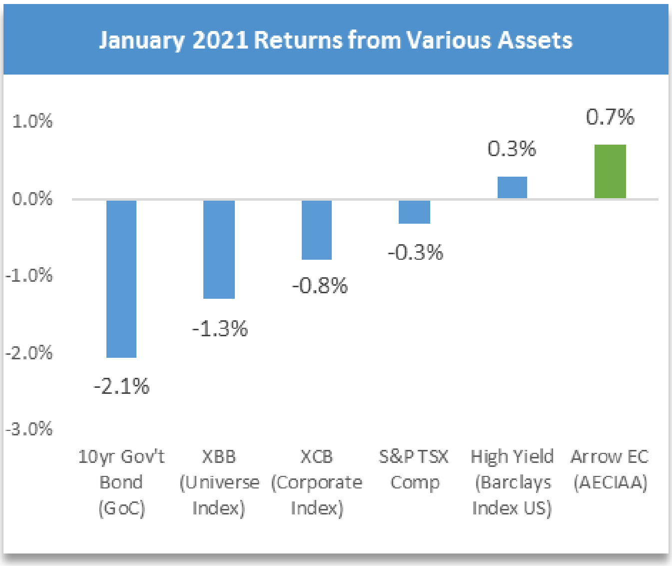
JANUARY 2021

January has reminded us of something we wrote last fall - “Investors don’t seem to mind positive correlation…so long as it is to the upside.” January saw positive correlation rear its head again, but this time to the downside, as significantly weaker interest rates and equity market short squeezes led both assets to close the month in the red. Early month equity euphoria ended with a new source of market volatility – the disruptive power of amateur day traders, often referred to as the “Reddit Army” – resulting in a -1.02% US equity return (S&P 500) and a -0.32% Canadian equity return (S&P TSX Composite) on the month. January was a reminder that the organization of many individuals can have significant impact – whether it be on Capitol Hill or in financial markets. Credit spreads weathered the volatility in both rates and equities extremely well, as Canadian investment grade (IG) credit spreads rallied 7bps, outperforming the US, where credit spreads closed the month unchanged.

Longer-dated interest rates spiked higher when a dip in Republican voter turnout in Georgia’s runoff election helped Democrats to flip two Senate seats. Democratic stimulus plans are sizeable and while the Fed clearly has no short term plans to raise rates, investors have started to demand a higher return on longer dated bonds. Ten year government bonds sold off 21bps in Canada and 15bps in the US in January, and many analysts think this is just the start of it. Continued monetary stimulus, the expected surge in government debt, the anticipated rollout of COVID-19 vaccines and the resulting pent-up spending all point to higher rates by end of 2021. A sustained spike higher in yields would make equity valuations even more unattractive than today’s lofty levels – further reinforcing the potential for positive (downside) correlation between rates and equities.

DIVERSIFICATION BENEFITS OF EAST COAST STRATEGY

The diversification benefits of East Coast shone in January as most assets saw negative returns this month. As shown on the chart at right, corporate bond and universe bond funds, which have very high correlations to interest rates, were unable to deliver positive returns even with credit spreads rallying 7bps on average this month. The reason for this is that interest rate weakness (10yrs sold off 21bps) dwarfed any of the positive return benefit provided by credit spreads. . Also, interestingly, Barclays US High Yield (HY) index posted only a small positive return in January (+0.33%), showing the outperformance of higher quality investment grade (IG) credit over speculative (HY) credit. There are limited high-quality, positive yielding investment options currently available around the world. This makes high quality, investment grade credit desirable.



Source: Bloomberg, BMO Capital Markets, East Coast

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The problem is that most investors can only access investment grade (IG) credit via whole corporate bonds; meaning they are also taking on interest rate exposure. As you recall, IG corporate bonds are comprised of gov't bond yield (interest rate) + IG credit spread (the additional yield investors demand to buy corporate debt obligations instead of gov't debt). With whole IG corporate bonds yielding sub 2% on average, investors have a very small buffer to offset losses that would be associated with a further rise (sell-off) in interest rates.

Our mandate allows us to isolate IG credit spreads while removing (via hedging) the interest rate exposure of whole corporate bonds. We believe active management is key in this market environment - our strategy avoided the large losses incurred from rising long dated interest rates (yields higher = prices lower) in January.

The current market environment is challenging for investors. Balancing risk vs return potential is extremely difficult. Fixed income (bonds) has traditionally been the safe haven for investor portfolios; however, if rates continue to rise (which they have in the first week of February), all traditional fixed income funds will struggle to earn a positive return. If they stop rising from here, return expectations remain in the 1-2% range for full year 2021 (based on current yields). Equity markets are hitting new all-time highs again while valuations appear extremely stretched. As mentioned above, credit spreads have rallied but still remain weaker (wider) than historic levels. Our flexible, active mandate allows our investment team the opportunity to continually execute trades that offer incremental return per unit of risk. We believe every single basis point is valuable in this environment. At the higher portfolio level, we will remain patient – looking for true dislocations and opportunities before adding any substantial risk.

MARKET SNAPSHOT

Canada		US	
Credit (Bloomberg Barclays Cdn Corporate Index)	Rallied 7bps	**Credit** (Barclays US Aggregate Credit Index)	unchanged
Equities (TSX Composite)	-0.32%	**Equities** (S&P 500)	-1.02%
Interest Rates (GoC 10yr)	Weakened 21bps	**Interest Rates** (TSY 10yr)	Weakened 15bps

Thank you for your continued interest in the Fund. For further information, please contact your regional Arrow Capital Management representative.

Sincerely,

East Coast Fund Management Inc.