EAST COAST MARKET COMMENTARY

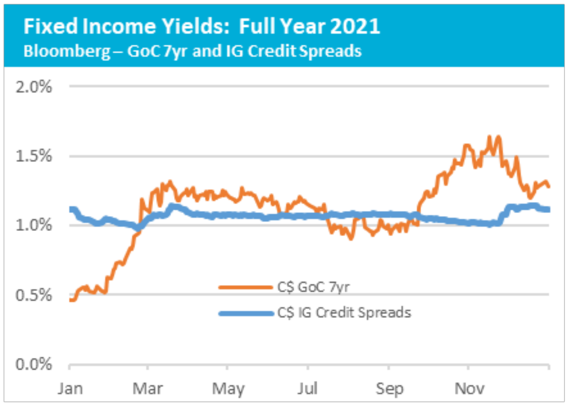
DECEMBER 2021

Developed equity markets around the globe finished the year on a positive note, as stronger than expected earnings growth helped US equity markets close +4.47% (S&P 500) and Canadian equities close +3.1% (TSX Comp) in December. Equities had all but forgotten the large volatility spike in the end of November when Omicron reared its head, as data out of South Africa and UK indicated a lower-risk of severe illness. In the end, equities had another gangbuster year, but many investors are left wondering how equity markets could have had such a seemingly straight-line rally, while so much uncertainty remains – inflation, rates, Omicron etc. Investment grade (IG) credit spreads rallied in the US (-7bps) but were totally unchanged (0bps) in Canada.

Interest rates in the US (10yr Tsy) were weaker by +7bps as the Dec 13th Fed meeting showed a Central Bank that was ready to combat inflation, by raising rates sooner and faster than the market anticipated. The Fed has accepted inflation is no longer just 'transitory' in nature. Canadian interest rates (10yr GoC) rallied to end 2021, with yields lower by 14bps. Canadian rates sold off more substantially than the US in November so BoC rate hikes in 2022 were already priced in to start the month.

INTEREST RATES MOST VOLATILE SEGMENT OF FIXED INCOME MARKET IN 2021

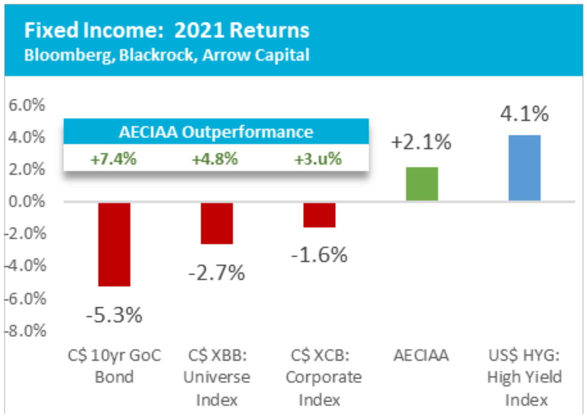
Throughout 2021, interest rates (government bond yields) have proven to be the most volatile fixed income asset in Canada. The chart below shows Canadian 7yr government bond yields (in orange) sold off as yields moved higher by 82bps, from 0.46% to 1.28%, over the course of the year and were extremely volatile. Conversely, credit spreads, or yield, of Canada's highest-quality (IG) corporate bonds were unchanged on the year (at 111bps) and exhibited very little volatility over the last 12 months. Interest rates volatility is likely to continue as central banks around the globe will be forced to raise rates to curb inflation, while simultaneously trying to ensure they do not derail growth prospects in the process. Ultimately, we believe 2022 will be another year of higher interest rates and disappointing returns from traditional fixed income.



Source: East Coast Fund Management

HIGHER INTEREST RATES LEAD TO LOSSES ACROSS TRADITIONAL FIXED INCOME FUNDS

As our investors know, when yields move higher, prices move lower (given their inverse relationship); therefore, the rise in government bond yields (interest rates) mentioned above led to sizeable fixed income losses in 2021. The bar chart below shows the 2021 returns investors received from various fixed income assets.



Source: East Coast Fund Management

The benchmark 10yr government bond (GoC 10yr) in Canada ended the year with losses in excess of -5%. All bonds, including corporate bonds, have a government bond (interest rate) component and an additional credit spread, which compensates investors for buying the debt of an investment grade company rather than that of the government. As a result, even corporate bonds, whose credit spreads were unchanged on the year, suffered losses in 2021. Their significant positive correlation to rates overwhelmed any diversification benefit of owning credit spreads within a corporate bond. The US$ high yield index (HYG), which carries much greater risk, outperformed our strategy by only 2%. This index invests in speculative (non-IG rated) assets that we believe do not adequately compensate investors for their higher risk at this time.

The outlook for interest rates remains bleak. Bloomberg's survey of US economists shows strategists expect 10yr yields in the US to rise by more than 50bps+ on average in 2022 (from 1.51% to 2.04%). If predictions are true, a 50bps rate rise in 10yr yields would correspond to a rough price drop, or negative return, of -4.5%, and represent a sizeable headwind for fixed income assets to start 2022.

Inflation and interest rate uncertainty in 2021 has reduced traditional fixed income allocations within many portfolios. The white elephant that remains is a significantly overweight equity allocation, and no clear investment strategy to protect investor's capital if equities weaken. Mike MacBain, our CIO, discusses the investment team's outlook for 2022 in our December podcast. We remain committed to short-dated, high-quality Canadian IG credit, active management of interest rate exposure and defensive positioning to start 2022. We believe East Coast's alternative fixed income strategy has earned a place within any diversified investment mix.

MARKET SNAPSHOT

Canada		US	
Credit (Bloomberg Barclays Cdn Corporate Index)	0bps (unch)	**Credit** (Barclays US Aggregate Credit Index)	-7bps (rally)
Equities (TSX Composite)	+3.10%	**Equities** (S&P 500)	+4.47%
Interest Rates (GoC 10yr)	-14bps (rally)	**Interest Rates** (TSY 10yr)	+7bps (weak)

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

Sincerely,

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