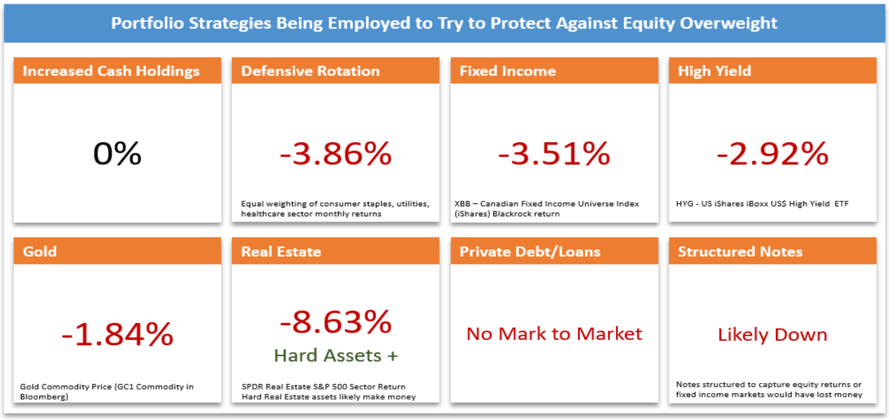
Arrow Capital Management Inc. *Experience. Active Management.*

EAST COAST MARKET COMMENTARY — JANUARY 2022

January was a very challenging market for all asset classes, but nonetheless a market dynamic that we have been preparing for over the back half of 2021. Outside of Energy and select few commodities, all asset classes were hit this month. Fixed income was not the safe haven that investors expected it to be. At current interest rate levels traditional fixed income can no longer provide the same annual returns, nor can it be an effective buffer against equity market weakness as it has been in the past. January was a good example of this – the S&P was down 5% and the bond index was also down 2.9%, resulting in a correlated negative monthly return rather than a buffer against equity market volatility.

EQUITY OVERWEIGHT: NO DIVERSIFICATION OPTION IN JANUARY

In the December update we introduced the chart below, which illustrates the difficulty that PM's have diversifying away from their overweight equity positions. We have been encouraging investors to reduce their overweight equity positions and allocate towards inherently low vol asset classes that are not correlated to rising interest rates, like AECIAA, for some time now. Reviewing this chart illustrates how difficult it is to find a low vol asset that is uncorrelated to interest rates.

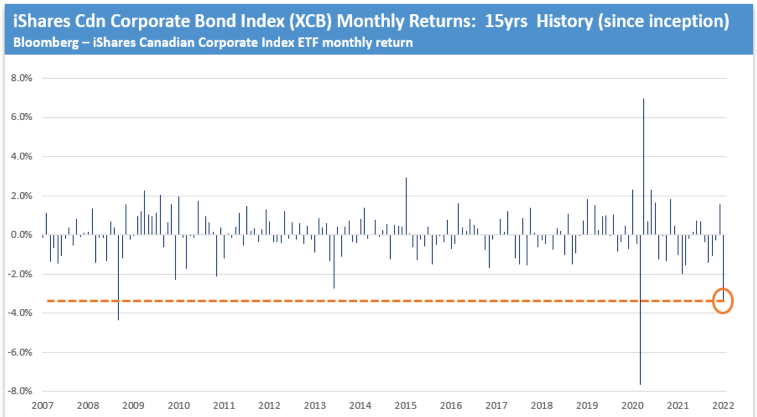


Source: East Coast Fund Management

Returns in January:
- Cash made a zero or very close to zero percent return, which given current inflation does not protect your purchasing power.
- Rotating into defensive equities, equally weighting consumer staples, utilities, and healthcare, delivered a monthly return of -4%.
- If you owned XBB, the Canadian Bond Universe index ETF, you lost -3.5%.
- If you owned the high yield index you lost -3%.
- If you owned real estate (i.e. Spider Real Estate Sector ETF) you lost -8%.
- Private debt and equity have no mark to market transparency, but it's hard to imagine the true value of these assets went up while everything else was going down.

TRADITIONAL BOND FUNDS: HIT BOTH WAYS

We would like to dig a little deeper on performance using XCB, the Canadian Corporate Bond index ETF, as the example. The chart below plots monthly returns since 2007 and illustrates that January was the third worst monthly performance over that 15-year period. This is because XCB is a traditional bond index tracking ETF and it got hit both ways – meaning, XCB lost money because credit spreads widened and XCB also lost money because interest rates rose in January.

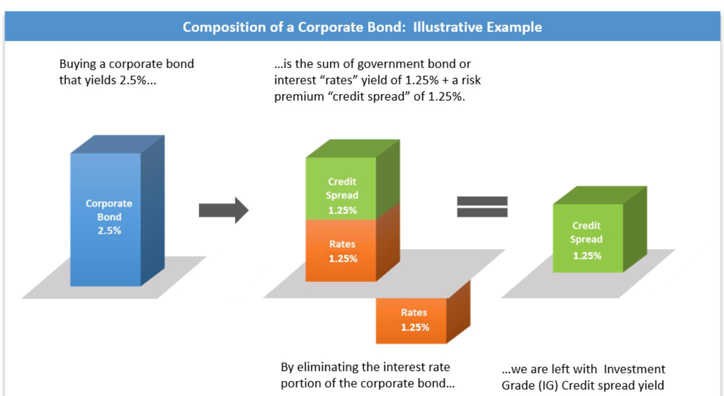


Source: East Coast Fund Management

This is the absolute nightmare scenario for bond managers and bond funds. There is almost nothing that a traditional passive bond fund manager can do to earn a positive return in this environment of rising interest rates. In today's market you want to be invested in a low volatility, fixed income asset with minimal interest rate duration: avoiding capital losses from rising equity volatility and rising interest rates is critical to earning a positive return in 2022.

HOW EAST COAST "HEDGES" INTEREST RATE EXPOSURE

How can one reduce one's interest rate exposure in their fixed income investments? In the chart below left, from the strategy intro deck, we explain using an example how we eliminate the interest exposure from the corporate investment grade bonds that we buy. The first thing we do is we buy a corporate bond that in this example, yields 2.5%. If we take the clothes off that corporate bond, there's two underlying risk and return characteristics embedded in that bond as the chart below shows. The first is the government of Canada yield (otherwise known as the interest rate) for the same maturity as the corporate bond, which in this case is 1.25% and the second is the credit spread or yield that corporate bond issuers must pay to convince investors to buy their bond instead of buying a government bond, or risk-free debt.

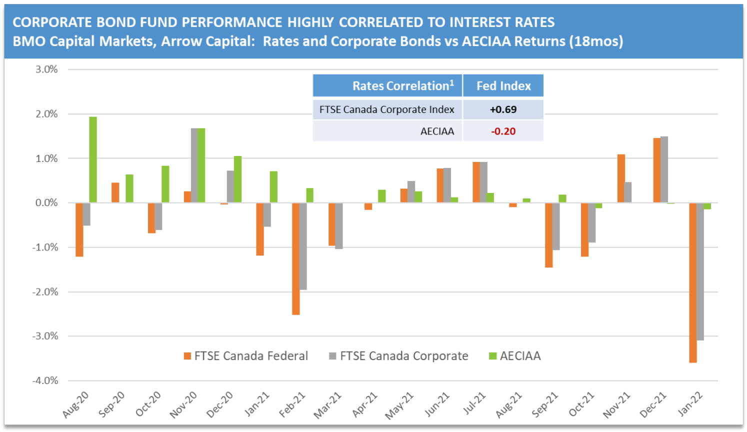


Source: East Coast Fund Management

In the example, that credit spread component is also 1.25%. These are the two risk and return characteristics that are embedded in the corporate bond that we bought. The way to eliminate the interest rate portion is to sell short the government of Canada bond. For example, if interest rates go from 1.25% to 2%, the yield on our corporate bond (all else being equal) will go from 2.5% to 3.25% resulting in a loss of the present value of 75 basis points in price terms on that bond. However, we will make the present value of 75 basis points on our short government bond position because that yield has risen from 1.25% to 2%. To recap, we lose 75 basis points on the bond that we're long, we gain 75 basis points on the bond that we're short. Interest rates have gone up from 1.25% to 2%, and there has been no P/L or return impact on the fund. The only exposure we're left with is that pure investment grade credit exposure that is negatively correlated to interest rate movements.

TRADITIONAL BOND CORRELATION TO INTEREST RATES OVERWHELMS

The chart below, illustrates why a low volatility fixed income asset, that is negatively correlated to interest rates, has been so important over the last 18 months, and hits home on the points that we've made before, which is that our expectation is that interest rates and equity markets are becoming or have become more correlated.



Source: East Coast Fund Management

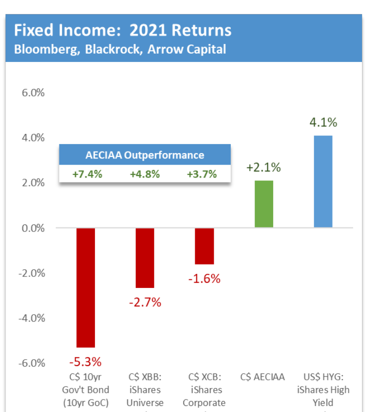
The chart shows how correlated the Canadian Corporate Bond index, the grey bars, and the Canadian Government Bond index, the orange bars, are to each other. The result is that it's virtually impossible to escape the losses associated with rising rates if you are a traditional corporate bond manager. Essentially every single month the federal index loses money so does the corporate bond index, and now in January 2022, very significant losses in the corporate bond index have come from rates rising.

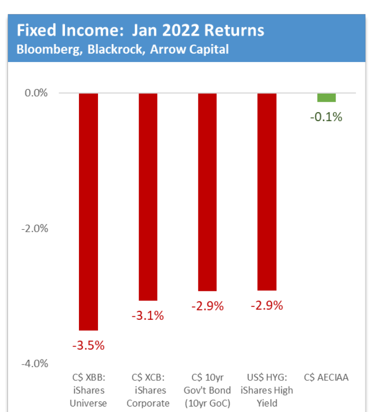
We included AECIAA returns, the green bars, over the same period. You can notice three things: AECIAA barely had a negative monthly return over this entire period, AECIAA monthly returns are not correlated to interest rates (Canadian Government Bond index), and AECIAA monthly return volatility is much lower than both the government and corporate bond index over the period. AECIAA is a perfect example of a low vol asset class that in January managed to sidestep negative returns resulting from rising interest rates and negative returns from widening credit spreads.

STRUGGLING FIXED INCOME PERFORMANCE

The left-hand chart of the two provided below shows full year 2021 fixed income returns:
10-yr Canada bonds down -5.3%, Canadian Bond Universe index ETF down -2.7%, Canadian Corporate Bond index ETF down -1.6%. AECIAA up +2.1%.

US High Yield was the outperformer, up +4.1%. However, if you recall in our December commentary, we said that the high yield market is going to come under significant strain from both rising interest rates and widening credit spreads.





Source: East Coast Fund Management

On the right-hand side is what happened in January:
Canadian Bond Universe index ETF down -3.5%, Canadian Corporate Bond index ETF down -3.1%, 10-yr Canada bonds down -2.9%.
US High Yield index down -2.9%.
AECIAA was the outperformer, near flat on the month (-0.1%)

January's market moves get right to the point of why we have been positioned defensively. Our low risk profile was validated in January as we managed to squeak out a small positive return while most asset classes were taking losses.

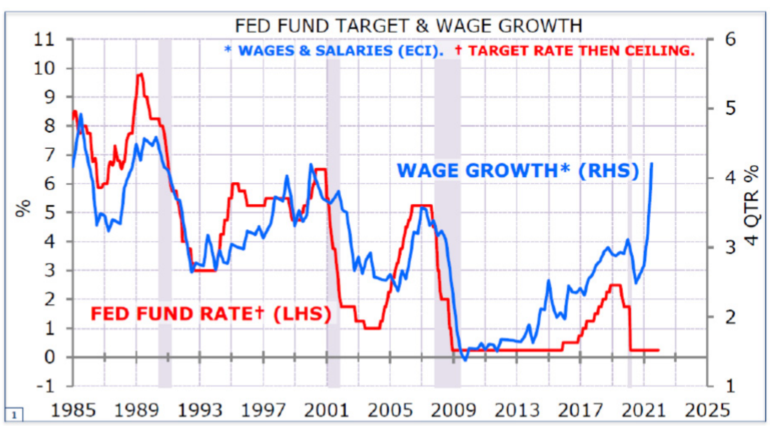
Has January's price moves changed our opinion? No, our view has not changed, and we believe that it's likely to continue to be a very difficult market, a very volatile market, and one that we want to stay defensively positioned in. Equity markets are down 10%, credit spreads are wider by about 10%, and valuations are more interesting.

The moves in January are yet another reminder of why we hedge interest rates and have been defensively positioned in the short term. That strategy has allowed us to avoid the -3%+ losses that traditional fixed income funds have taken to start the year.

WE BELIEVE THERE WILL BE MORE WEAKNESS

The last two charts help illustrate why we're still bearish on equities, interest rates and credit spreads. [Note: Please see the podcast from December for a more in-depth discussion of our investment team's market view and some key pieces of data that support our bearish view].

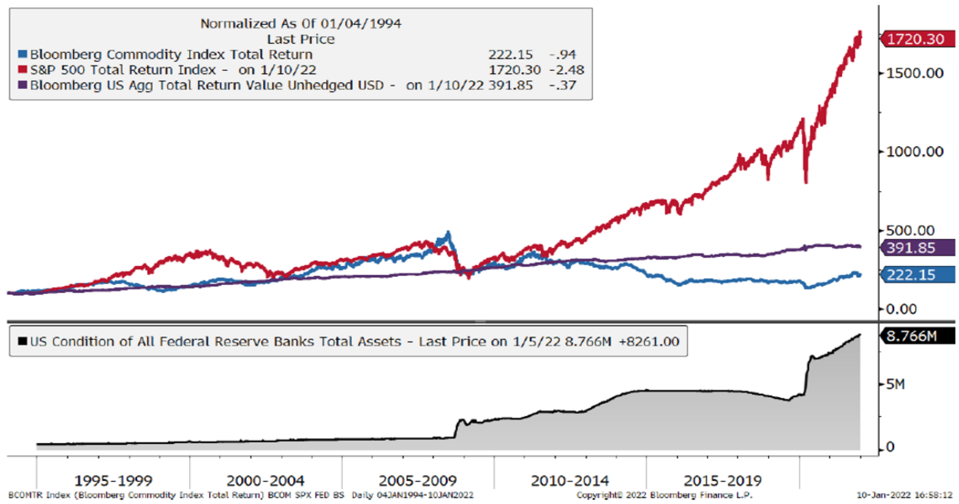
The first chart, at right, is one from Minnack Advisors. It's fantastic because it is so simple and the message is so clear. Wage growth is the blue line and FED funds rate is the red line. You can see how closely this has tracked over time over the last 40 years. This 100% explains why the FED pivoted so quickly and aggressively in December and didn't back down after a 10% drawdown in the equity markets at the next FED meeting. In fact, not only did they stand their ground, they came back more hawkish. Obviously, the market is pricing higher rates now, but the extent of how high they go is not baked into the market, in our opinion.



Source: East Coast Fund Management

This last chart, below, is from Doubleline, Jeffrey Gundlach's fund. We thought this was a great chart as well because it perfectly, and very simply, illustrates what we've been talking about for the last six months. The blue line is the commodity index going back to 1995, the purple line is the Bloomberg US Aggregate total return value (US Bond Index) going back to 1995 and the red line is the S&P 500 going back to 1995. What it shows is that prior to the GFC in 2009, all three major asset classes were performing largely in line with each other – up about 200% over 10 years. What started in 2009? Central Bank money printing, under the name of Quantitative Easing (QE). On the bottom chart is the FED's Balance Sheet showing how many bonds the FED owns. QE is effectively monetizing the US debt and increasing the amount of money in circulation. There is a very strong correlation from 2009 onwards between skyrocketing equity prices (as denoted by the red line S&P 500) and the growth of the FED balance sheet. Even the slope of the two lines shows strong correlation – balance sheet

sheet grows, and the S&P 500 rises, then Covid happens, balance sheet explodes, and the S&P 500 goes parabolic.



Source: East Coast Fund Management

What do you think is going to happen to global central bank balance sheets going forward? They will not be growing as much, then they will stop growing, then they will begin contracting. Our firmly held view is that as financial conditions tighten, and central bank balance sheets stop expanding, that equity valuations will flatline and then fall. Balance sheet expansion is scheduled to stop March 15th for the FED and they are talking about QT (balance sheet reduction) by the end of 2022.

We want to thank you for tuning in. January was a challenging environment for all markets, however it was a month that has validated our positioning over the last six months and has begun to put us in a position where opportunities going forward look much better than they have in quite some time. We are upbeat about that, and about the potential for the strategy to continue to perform well over 2022.

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.