Views from the Desk

Updates in the Fixed Income Marketplace

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Fixed Income Update March 30-April 3

We saw both fixed income and equity markets respond positively to both monetary and fiscal stimulus and the recent headlines that infection rates could have peaked in Europe and North America. The most impactful headline for fixed income and credit markets specifically was the speculation that Russia and Saudi Arabia agreed to cut oil supplies. This stabilized oil prices last week which jumped 33% in reaction to this news. A meeting was supposed to be held today between Russia and Saudi Arabia to finalize supply discussions, but this has since been pushed to Thursday. This meeting, once it occurs, will have a huge impact on credit spreads in both the Investment Grade and High Yield space. The corporate bond universe in Canada is 20% Energy, and there is also indirect exposure through sectors such as Financials and Real Estate. So, the price of oil has a huge impact on the entire credit market in Canada. If we look back to 2008, the set up was a lot different than it is right now. In '08 oil prices dropped to $28 a barrel, roughly to where oil is trading now but prior to the recession, oil was enjoying a massive run, whereas this time around, oil was already struggling even before the markets crashed in February. Today, another difference is the demand for oil is down considerably (no one is driving or flying while in quarantine).

Fixed Income's Role in a Balanced Portfolio

BMO's Aggregate Bond Index ETF (ZAG) tracks the Canadian fixed income universe which is a third government bonds, provincial bonds and IG corporate bonds. Its duration is about 8 years. Over the last few weeks, we experienced a massive liquidity event as investors looked to sell bonds and raise cash by any means possible. Therefore, bonds have underperformed peoples' expectations because of the corporate component in the aggregate mix. As the selling intensified in the corporate bond space, dealers could not take on any more capacity, so many bonds traded below fundamental values and sellers moved into more liquid areas such as government bonds. Liquidity continued to be challenged and even government bonds dislocated from their fundamental prices. But even though fixed income did not provide the security we may have expected as equities fell, a 60/40 portfolio still had less volatility and lower correlations to equity markets.

Corporate Bond Update- Downgrades or defaults on the horizon?

There has been some chat about downgrade risk within bond portfolios ever since Ford got downgraded to high yield last week. This led to some speculation that we would see more downgrades in the auto sector. The Energy sector is also vulnerable with the price of oil below $30. BBB-rated bonds are 10% of the Canada bond universe, and if a BBB gets downgraded it is no longer investment grade. Most mandates in Canada require IG bonds only, so if a BBB gets downgraded, there becomes a lot of selling pressure on this specific bond. Downgrade risk can be mitigated by using an ETF for two reasons: the portfolio has time to sell the bond, and the portfolio's diversification will mitigate the impact of the downgrade. Within an ETF, if something gets downgraded, we have 30 days to remove the security from the portfolio. So, as the street starts selling this bond, we can take advantage of timing and as selling starts to dissipate we can sell at a more opportune time. Within ZAG there are 1,400 positions; it's extremely diversified. Ford is 17bps of this portfolio, so a downgrade in this portfolio is more muted than within a high conviction strategy.

Selling Bond ETFs and Funding Redemptions

We use sampling to manage our fixed income portfolios because the fixed income market is an inventory-based market and it is very challenging to get exposure to the entire universe. Sampling makes it advantageous for liquidity. The ETF is so diversified and so if we have to raise a larger sum, for example $25 million, we can sell $1 million pieces, which is more digestible to the market. And because BMO is a larger player in the Canadian bond market, we interact well across the street and have great relationships with dealers and desks to find another side for our trades. Smaller managers would have a harder time doing this.

Fixed Income Trade Ideas for Bulls and Bears

An ETF is a great way to get exposure to fixed income right now because it is very liquid and very diverse. Credit spreads have widened, and downgrade and bankruptcy risk are still present, so diversification helps minimize company specific risk.

Bull Trade Idea #1 BMO US High Yield Corporate Bond Index ETF (ZHY/ZJK): Credit spreads in high yield are about 800bps above Treasuries, and these spreads could widen further. But long-term, spreads here aren't sustainable. Historical averages say high yield spreads tend to live around 300bps above treasuries.
Bull Trade Idea #2 BMO BBB Corporate Bond Index ETF (ZBBB): This is a more conservative approach to credit without dipping into the high yield space. BBB's are still investment grade, but they are the riskiest segment in the IG space. BBB's in Canada are roughly 2.3% above Federal bonds right now whereas before it was 1.3% above. If a bond gets downgraded, the ETF offers diversification and can better manage the downgrade. ZBBB offers exposure to the BBB segment of the Canadian corporate bond universe with maturities of 1-10 years.
Bull Trade Idea #3 BMO Laddered Preferred Share ETF (ZPR): The Canadian pref share space has struggled from both an interest rate and credit perspective. The Bank of Canada has said rates will not go negative, so we can assume that interest rates have bottomed out and credit spreads are not sustainable at current levels. Pref share issuers are from high quality sectors such as banks and insurance, and within the energy sector they are all pipeline companies. The yield on ZPR is 7.5% and taxed as dividend income. This sector will rebound well once the market bottoms out.

Bear Trade Idea #1 BMO High Quality Corporate Bond Index ETF (ZQB): If you are pessimistic on the economy and believe credit spreads will continue to widen, you want to focus your portfolio on quality and liquidity. Credit spreads within the A+ space have taken an unfair amount of selling because they are the more liquid segment of the corporate bond space. These are currently trading 1.7% above Fed bonds, normally the spread is just 40bps.
Bear Trade Idea #2 BMO Ultra Short-Term Bond ETF & BMO Ultra Short-Term US Bond ETF (ZST & ZUS): If you want to focus on liquidity ZST and ZUS offer a portfolio of short-dated (less than one year to maturity) T-bills and corporate bonds. The T-bills add liquidity and the corporate bonds provide additional yield.
Bear Trade Idea #3 BMO Aggregate Bond Index ETF (ZAG): This is never a bad idea because the portfolio is so diversified. With over 1,400 bonds and exposure to federal, provincial and corporate sectors, there is always something here that's working because it's exposed to everything. And for 8bps it is an extremely cost-efficient way to get exposure to the entire Canadian fixed income universe.