Views from the Desk

Upgrading to Quality in Your Fixed Income Portfolio

Macro Update:

- The S&P 500 Fear levels recently exceeded the 2008 crisis. Recently, markets have been funding liquidity by any means necessary (margin calls, fund redemptions, moves to cash).
- Equities, bonds and commodities became correlated with the large moves to cash. This means, there was indiscriminate selling with quality assets being sold in addition to junkier assets.
- The quality sell-off was even more prevalent in the bond market because investment grade (IG) bonds were used to fund liquidity. From March 9th to the 20th, IG bonds underperformed both high yield bonds and the S&P 500, even though they are the highest quality and the highest on the capital structure.
- We saw bids on cash rich companies come in well below their fundamental values (ie: Apple bonds were $7 lower), and CDX US IG spreads and Canadian AAA/AA spreads have widened significantly.
- The Fed's corporate bond buying program can be beneficial for "risk-assets", as buying corporate bonds frees up inventory space of fixed income dealers and allows them to price assets more accurately. Additionally, it could create liquidity in bonds, allowing asset allocation managers to fund equity trades and move into risk assets, moving back to target weights.
- Bonds with high quality issuers have taken an unfair share of the sell-off in recent weeks, given their more liquid nature than BBB bonds. As a result of the forced selling, recently traded values of corporate bonds rated A and higher have disconnected from fundamental values. While spreads in A+ bonds could widen further, investors will still need to fund liquidity, so we believe investors with a longer-term view could take advantage of the forced selling and buy high quality bonds at a discount.

Canadian AAA/AA spreads have widened:

CDX IG spreads have widened significantly:

Source: Bloomberg March 26, 2020

The market can reverse course and go lower, but investors may want to take advantage now of the market sell-off by averaging into the market at attractive valuations, and upgrading to quality assets that will be core, long-term positions.

If you want to add quality fixed income to your portfolio, you may want to consider buying:

- **BMO High Quality Corporate Bond Index ETF (ZQB)**
- **BMO US IG Corporate Bond Index ETF (ZIC), U.S. dollars (ZIC.U), Hedged to CAD (ZMU)**

BMO High Quality Corporate Bond Index ETF
ZQB
Duration: 3.4 Distribution Yield: n/a | Q
Yield to Maturity: 2.01%
Mgmt Fee: 0.10%
Risk Rating: Low
new

BMO Mid-Term US IG Corporate Bond
ZMU hedged to CAD | **ZIC** unhedged USD traded | **ZIC.U** unhedged
Duration: 6.2 Distribution Yield: 3.4% | M
Yield to Maturity: 2.2%
Mgmt. Fee: 0.25% **Risk Rating:** Low

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