HPR Quarterly Commentary

Q2, 2020

General Market Review

In Q2 2020, sentiment was reinvigorated, and risky assets got some much-needed reprieve after the worst meltdown since the global financial crisis. Decreasing fears of the spread of the virus, along with unprecedented support measures unleashed from both monetary and fiscal authorities, helped the risk-on trade and propelled markets higher.

On the other hand, government bond yields remained well-anchored, with major central banks slashing rates to rock bottom levels and collectively expanding their balance sheets to ensure that the economic crisis didn't morph into a financial meltdown. Investors are speculating that global growth will recover as lockdowns ease and economies progressively reopen. There is a tug of war between risk assets looking for a V-shaped recovery and government bond markets looking for an L-shaped recovery. The S&P 500 is down just 3% this year, the NASDAQ is at an all-time high, oil is back over $40 and the price of copper has bounced significantly. So far, massive amounts of policy support are outweighing the recent flare-up in virus cases. Investors are clearly focused on the medium -term amid progress on potential vaccines and better-than-expected economic data.

These developments caused the 10-year Canada yield to fall 18 basis points ("bps") to 0.53%, the five-year Canada yield to decrease by 22 bps to 0.37% and for the yield curve to flatten. In this risk-on environment, mid-term provincial bond spreads decreased 38 bps on average to 74 bps. Corporate spreads tightened 91 bps on average to 183 bps.

The Canadian preferred share market rebounded in Q2 after its worst-ever quarter in Q1 following the strong equity and credit performance and outlook, despite lower interest rates. The S&P/TSX Preferred Share Index returned 15.02%, while the Solactive Laddered Canadian Preferred Share Index (100% rate reset) returned 15.21% in Q2. Fixed rate perpetual issues outperformed in Q2, while fixed reset issues with low reset level and floating rate issues underperformed. Utilities, banks NVCC and insurance outperformed in Q2 while real estate and telecoms underperformed.

Portfolio Review

In the quarter, the overweight position in fixed rate perpetual and in fixed reset with mid reset level contributed to the outperformance. Security selection was the key factor contributing to the outperformance in the quarter. The underweight position in fixed reset with high reset level and with issues with floor, and the overweight position in floating rate preferred shares, reduced the outperformance. Insurance, utilities and telecoms were the top positive contributors for the quarter.

Over the last quarter, we have continued to improve the quality of issues for a "lower-for- longer" interest rate environment within our fixed reset allocation by reducing our exposure to fixed reset with low reset level and by increasing our allocation in fixed reset issues with high reset level and issues with floor features. We also reduced our exposure to floating rate preferred shares.

Outlook

COVID-19 will remain front and centre for financial markets. Governments have and will continue to respond with drastic measures that are necessary to bridge the gap until the economy can fully re-open. We are confident that these decisions will eventually work, but the duration and severity of the impact on economic growth remains uncertain, especially in certain sectors. Q2 growth will be extremely weak, but we are expecting activity to resume in the third quarter of 2020, albeit at a subdued pace. We expect Canada rates to be kept low for a long period of time, but volatility will present tradeable opportunities. Credit will continue to perform well, especially with government yields anchored. However, we do not expect a straight-line recovery and volatility will remain above average.

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The Canadian preferred shares market has performed much better in Q2 but continued to lag other asset classes, though it remained attractive compared to the equity market and fixed income. The market should remain volatile over the next months and quarters and follow the volatility of the bond and equity markets driven by headlines on the COVID-19 pandemic and the success of reopening the economy. Lower rates for longer and negative technical would cap the upside over the short term, and retail investors should continue to be a net seller.

We think most of the outperformance of the preferred shares market for the remainder of 2020 will come from the compression of credit spreads, and we think there is significant upside with the asset class on a 12-month horizon. The primary market should continue to be quiet as valuations remains expensive for issuers. Flows into the ETFs will continue to be an important driver of daily volatility. In this environment, most of the preferred shares are attractive, but we think the fixed reset issues with a mid-reset level (between 300 bps and 400 bps) are providing the best risk-reward ratio.