HFP Quarterly Commentary

Q2 2020

Market Review

In Q2 2020, the sentiment was reinvigorated, and risky assets got some much-needed reprieve after the worst meltdown since the 2008 global financial crisis. Decreasing fears of the spread of COVID-19, along with unprecedented support measures unleashed by both monetary and fiscal authorities, helped the risk-on trade and propelled markets higher.

Additionally, government bond yields remained well-anchored, with major central banks slashing rates to rock bottom levels, while collectively expanding their balance sheets to ensure that the current economic crisis doesn'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 a 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 rebounded significantly. So far massive amounts of policy support are outweighing the recent flare-ups in virus cases. Investors are 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 2020 after its worst-ever quarter in Q1 2020, following the strong equity and credit tone despite a lower interest rate. 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 2020. Fixed-rate perpetual issues outperformed in Q2 2020, while fixed reset issues with low reset level and floating rate issues underperformed. Utilities, banks, non-viability contingent capital ("NVCC") and insurance outperformed in Q2 2020, while real estate, telecoms and energy underperformed.

Quarter in Review

The underweight position in fixed reset with high reset level and issues with floor features mostly explained the underperformance. Our overweight in fixed-rate perpetual preferred shares and hybrids reduced the underperformance. Our active positioning in insurance and telecoms contributed positively to the fund's performance during Q2 2020 while banks NVCC and diversified financials contributed negatively.

Over the last quarter, we have continued to improve the quality of issues within the portfolio for a "lower for longer" interest environment by increasing the average reset level on our fixed reset issues and our allocation to issues with floor features.

Outlook and Positioning

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 reopen. 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 2020 growth will be extremely weak, but we are expecting activity to resume in the Q3 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.

The Canadian preferred shares market has performed much better in Q2 2020 but continued to lag other asset classes yet remained attractive versus the equity and fixed income markets. Preferred shares should remain volatile over the next months and quarters, as headlines on the COVID-19 pandemic and the success of the reopening of the economy should continue to drive market prices. Lower rates for longer and negative technicals would cap the upside over the short term; retail investors should continue to be net sellers. We think most of the outperformance of the preferred shares market for the remainder of 2020 would come from the compression of the credit spreads, and we think there is important upside with the asset class on a 12-month horizon. Primary market should continue to be quiet as valuation is 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.