FIXED INCOME - SECOND QUARTER REVIEW

The Confidence Game

Heading into the start of the quarter, for the first time in anyone's living memory, the world was forced to shut down and hibernate (or "social distance") due to the threat of COVID-19. While countries and cities around the world slowly reopened throughout the quarter, most of the quarter seemed like a blur- people woke up confused about what day it was, where they were working and how or where to shop. Many had assumed back in February that we would be "done with this virus" post the normal flu season but, here we are entering Q3 still trying to understand it and get ahead of the battle to "flatten the curve".

With the government's reactive policies in full force, the priority of getting money directly to households has helped to ensure Canadians can meet their near term needs during social distancing and mandated closures. Being in Toronto, the vast majority of our team is still working from home but with a phased-in approach to return to the office over the coming quarter. While businesses and activities across our country are opening, resuming a "back to normal pre-covid routine" seems unlikely in the near term without a vaccine or effective treatment plan. Either way, the measured approach to reopen in Canada, hopefully still allows the country to maintain a flatter incidence curve through the anticipated second wave of infections. The experience we have seen in the US because of a ramp up in testing but also for some states (particularly Texas/Arizona/Florida) who have been aggressive in their opening up policies and time frames to relax restrictions is a large spike in cases. Florida, Texas and Arizona have within the last week reversed some of their easing measures in response. The question now, is how confident and comfortable will our governments (federal, provincial and municipal), in combination with the medical community, be in allowing for a resumption of "normal" activities in and across Canada?

For those watching the markets there have been many records set this quarter. Things that once not long ago seemed unlikely, were all fair game.

Highlights For The Quarter

-$37.62 The closing price of a barrel of WTI crude oil in USD on April 20, 2020 – first time in history that oil closed with a negative price

+13.7% Canadian unemployment rate for May – highest in the last 50 years, peaked at 8.7% during the 2008 financial crisis

521Bln Bank of Canada's assets on its balance sheet, more than 6x larger than during the peak of the 2008 financial crisis and is expected to keep growing

~250Bln current estimate of the Canadian Federal Government deficit for 2020-2021, even during the financial crisis annual federal deficit did not exceed 100bln at the peak

24 number of weeks the Canada Emergency Response Benefit (CERB) will last (extended by 8 weeks from the initial mandate) – a telling sign that the recovery will be slow(er) than initially thought

2.77MM number of people tested for COVID–19 in Canada during the first half of the year, which is only about 7% of the Canadian population

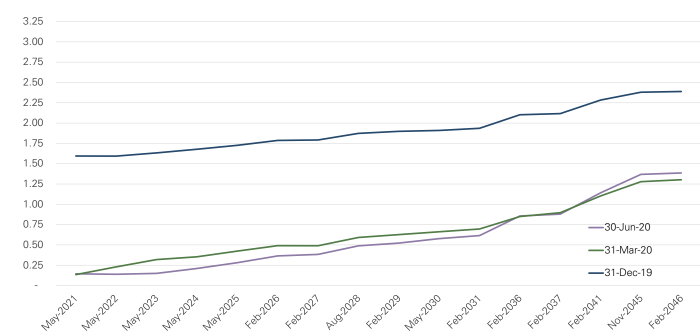
104,204 The number of people confirmed to be infected with COVID–19 in Canada (or <4% are infected that were tested)

8,591 The number of people in Canada who died from COVID-19 (8% of the people infected)

Quarter Review

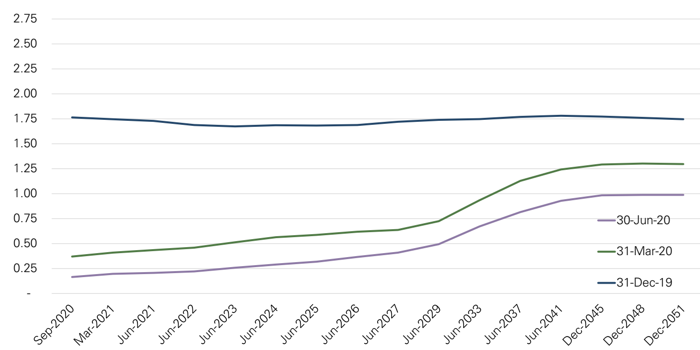
During the quarter, the Federal Reserve ("the Fed') kept interest rates unchanged at 0% (lower bound). The expectation is that the FED will keep interest rates at the lower bound through 2021 at least. The Fed has reiterated several times negative rates is not appropriate at this junction and would continue to use other tools in its tool box to get through the near term.
Interest rates for the quarter moved anywhere from -14bps to +9bps, with a steepening of the curve.

Exhibit 1: US Yield Curve



Source: Bloomberg

Exhibit 2: Canada Yield Curve



Source: Bloomberg

The Bank of Canada kept their overnight rate unchanged at 25bps. The Bank of Canada is also not contemplating negative interest rates at this point. Interest rates for the quarter moved anywhere from 21bps to 31bps lower across the curve, with the yield curve a bit flatter.

Market volatility continued with the 1 year Government of Canada bond moving 59% from peak to trough (vs. 68% in Q1). Canadian investment grade corporate spreads were tighter anywhere between 39bps to 101bps across the curve and rating categories during the quarter. With higher quality AA bonds tightening the least, while BBB credits tightened in the most.
Returns for various fixed income asset classes are shown in the table below.

Exhibit 3: Returns for Fixed Income Asset Classes

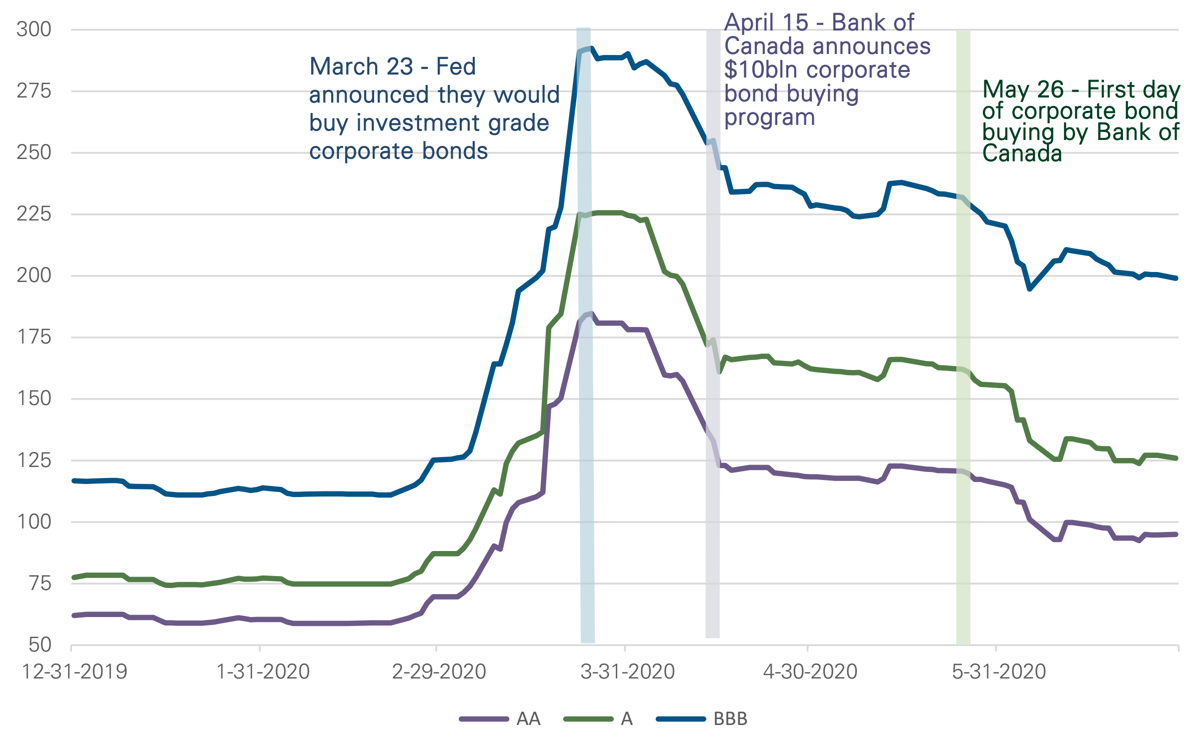
Asset class returns	Q2/20	Q2/19	YTD 2020	YTD 2019
Bond Universe Index	5.87%	2.51%	7.53%	6.52%
Corporate Bond Index	8.09%	2.68%	5.41%	6.82%
FTSE High Yield Canadian Index	7.62%	0.85%	-2.08%	4.91%
S&P/TSX Preferred Index	14.96%	-2.69%	-13.62%	-1.93%

Bank of Canada Welcomed New Governor Tiff Macklem

On June 3rd, the Bank of Canada welcomed Tiff Macklem as its new Governor. Governor Macklem is not new to the Bank of Canada having joined the bank back in 1984 and left twice for other opportunities. This is his third time back to the bank, with his most recent tenure at the bank working during the financial crisis as the Senior Deputy Governor alongside Mark Carney from July 2010 to May 2014. He was most recently the Dean at the Rotman School of Management.

Central Bank Boosts Confidence in the Canadian Corporate Bond Market

Exhibit 4: Canadian Corporate Spreads (5 Year)



Source: Compiled with data from BMO capital markets, Cumberland Investment Counsel

We have highlighted 5 year corporate spreads in Exhibit 4. Spreads were at its widest this year on March 23rd before the Fed said they would purchase investment grade bonds. While the Fed's announcement was for US denominated corporate bonds, equity markets in both Canada and US both saw its bottom that day as well as credit spreads saw its peak in Canada. Canadian corporate spreads contracted with rumours the Bank of Canada would likely follow suit (though to be clear, it would be the first time the Bank of Canada would embark on this type of mandate). On April 15th, three long weeks after the Fed's announcement, the Bank of Canada finally announced its intention to purchase investment grade corporate bonds in the secondary markets (up to $10bln). While that may seem like a big number, the Canadian corporate bond market is in excess of $500bln in size. While there are restrictions to what the Bank of Canada can buy, the support of these purchases impact less than 2% of the corporate investment grade universe (just to put it into perspective). While logistics were being ironed out, it took another month before more details about the facility would be disclosed and TD Asset Management was appointed to help facilitate the purchases over the course of the year. The Bank of Canada did not start buying corporate bonds until May 26th in the secondary markets. As you can see in the chart, most of the spread tightening happened prior to the actual buying. Once investors felt confident that the Bank of Canada was going to be the backstop, spreads continued to move tighter up to and continuing into the Bank's actual purchases. While spreads are still wider than levels seen at the beginning of the year, they are about 100bps tighter for 5 year bonds across the rating categories.

In terms of the results of the bond buying program so far, the Bank of Canada have been in the market buying every Tuesday and Thursday since May 26th. They have purchased a par amount of $133.4MM out of a potential of $1.4bln (or 9.5% of eligible maximums). Note that the facility has a limit of $10bln so the Bank is only 1.3% utilized at this point in time, which is good if the markets react negatively again: the Bank will have ample liquidity to purchase bonds when actually needed. The Bank of Canada's announced support helped the corporate bond market liquidity return well before its actual purchases as investors gained confidence from just the announcement. In addition, that support also helped with allowing issuers to refinance bonds during the pandemic at record pace: Q2 saw $45billion of new issuance in the investment grade corporate bond market vs. $31 billion last year Q2 (a 47% increase).

Outlook & Strategy

Second quarter earnings reports will be released over the next 8 weeks and it will be interesting to see what companies report given many companies pulled forward-looking guidance earlier this year. We continue to do the credit work on our investments and continue to be biased to shorter dated corporate bonds for income.

Things we continue to consider when we are investing:

1) the second wave of infections around the world may have longer-term damage to the economy and a slower recovery than what people were initially thinking;

2) low WTI oil prices will still be a drag on Canada and we expect oil to be rangebound at this level for the near term given point one above and so much supply being sidelined from production cuts that could be back online if prices spiked higher; and

3) while the Bank of Canada has been supportive of the bond markets and is thought to be a backstop for illiquid bonds, it does not mean companies will be immune to defaults nor bankruptcies.

At the end of 2019, 89% of the bonds in the Canadian Bond Universe traded above par. At the end of Q1, 79% of those bonds trade above par, but at the end of this quarter, 98% of the index traded above par. While it is clear that the recovery from COVID-19 is still a work in progress and there is no clear path, investors have gained greater confidence with the Bank of Canada being its backstop. All-in bond yields in most instances are now even lower than where we started the year. Bond investors are clamouring for yield, maybe even stretching given government bond yields are so low with a 30 year Government of Canada bond yielding 0.99% and the Canadian investment grade corporate bond index yielding 2.1%. We remain cautious on ensuring a balance between the risks and returns.

I hope everyone is in good health and remains in good health.

Take Care,
Diane Pang

Lead Manager,
Cumberland Fixed Income*
July 2, 2020

*Cumberland Private Wealth refers to Cumberland Private Wealth Management Inc. (CPWM) and Cumberland Investment Counsel Inc. (CIC). Diane Pang (a Portfolio Manager at CIC) is the lead portfolio manager for the Cumberland Income Fund and the Kipling Strategic Income Fund. NCM Asset Management Ltd. (NCM) is the Investment Fund Manager to the Kipling Strategic Income Fund. CPWM, CIC and NCM are under the common ownership of Cumberland Partners Ltd.