PENDER FIXED INCOME

THE MANAGER'S MONTHLY COMMENTARY – JUNE 2022

The Pender Corporate Bond Fund emerged from June, a volatile month, down 3.2%[1]. Although the result was hardly what we had hoped for, the month did seem to show signs of slowing inflation which may be an important potential catalyst for reversing the current market weakness.

There were not many portfolio bright spots in a market driven by liquidation and downward re-rating. However, a stronger bid for our position in the long-defaulted 2013 bonds of Thornburg Mortgage, Inc. drove that line six points higher, as progress was made towards an ultimate payout from a series of legal claims dating back to the 2008 financial crisis.

That small gain was a rarity as most bond prices fell precipitously in June. In the government bond market, investors discounted even higher policy rates as central banks continued in their tightening ways. In corporate credit, recession fears led to further volatility, with all tiers of credit exhibiting wider risk premiums, most noticeably for entities without robust current-period profitability.

Relatively speaking, front-end investment grade credit fared better, with our position in PepsiCo, Inc.'s (NASDAQ: PEP) 2024 notes down less than 1% for the month. Longer-dated positions in high yield issuers like recently re-organized Windstream Holdings, Inc. and Coeur Mining, Inc. (NYSE: CDE) showed markdowns in excess of 10% in June. In the case of more volatile positions such as Windstream and Coeur, while we do not enjoy the price movement, we believe valuation coverage to be more than adequate to protect our capital through a downturn.

Half Time Break in 2022's Grind – Where We Go From Here?

A few minutes by car heading out of Vancouver in a northerly direction, one comes across a popular hiking trail leading up Grouse Mountain. "The Grind," as it is known, is a steep and punishing trail populated by sweaty hikers and the occasional bear. On a tree at about 450 metres of elevation into the climb is a blue "1/2" marker, and beside that tree is a makeshift bench which can serve as a nice spot to rest and reflect before pushing on towards the summit.

Six months into one of the most challenging years in bond market history, we recognize that 2022 has turned into investing's version of "The Grind" – long and difficult, and occasionally sweaty – and so the holiday weekend that arrived at the end of June does evoke that quiet wooden bench and the reflective pause that comes with it. A few thoughts emerge as we rest at the half-way point of the year.

Inflation is weakening: You can see the signs everywhere. Look at the commodity complex. Steel and lumber, for instance, are both down more than 50% from their recent highs. Financial conditions are tightening. Consumer confidence has plummeted. And so, it is not surprising to see sovereign bonds and higher-grade credit catching a bid.

Profit margins are under pressure: It stands to reason that if wages are up, if cost of goods are up, and if interest charges are up, then earnings, generically speaking, must be lower. And so, despite the buoyant expectations of the early post-Covid rebound, we expect a challenging earnings picture for many companies. The relative winners in such an environment should be companies that can pass along cost increases easily and/or companies that benefit from relatively stable underlying demand.

Lower tiers of credit are more challenged than higher-grade: As the economic weather has turned from sunshine to rain, we are witnessing a speedy reversal of relative performance in credit markets. Over the past twelve months, higher-yielding but lower-rated credit was more able to withstand the impact of rising risk-free rates. But recently that trend has reversed as default risk replaces duration as the

[1] *All Pender performance data points are for Class F of the Fund. Other classes are available. Fees and performance may differ in those other classes.*

biggest potential drag on returns. Unlike duration, default risk is less homogenously priced into the market, so the key is really to avoid unpriced default risk.

Central banks are still in tightening mode: What makes the current downturn a bit different from 2020 and even 2016 is that, despite an evident market drop and rapidly decelerating economy, the Federal Reserve and other central banks continue to raise rates. The Fed's fear of allowing an entrenched inflationary cycle to take hold, for the moment at least, seems to be taking priority over maintaining economic expansion or promoting full employment.

Now thinking can be useful, but it is doing that tends to drive results. So, given this picture, what are we looking to do? **First,** we are continuing to allocate towards the investment grade end of our spectrum, as we anticipate this area will be first to benefit from a waning inflation picture and should also be most resilient to risks of recession. **Second,** within the high yield part of the portfolio, we are pushing increasing weight into the most economically resilient issuers with strong coverage factors. **Third,** we are extending slightly more duration than we have recently as we believe longer-term bonds, at least in the higher grades, stand to generate a higher total return should rates subside.

But while these are all directions that we believe are sensible in the current context, we never want to let top-down strategy prevent us from capitalizing on an excellent bottom-up idea. And so we continue to turn over rocks, particularly in the deeply discounted segment of the market, to see if we can find situations where market pricing has moved too far. As always, we remain on the lookout for a great risk-adjusted return opportunity in a very low-priced bond.

New Positions

In June our largest single purchase was an eight-year Government of Canada bond due in June 2030. We consider the 16-point decline in this issue in 2022 (to a point where 2030 Canadas sported a mid-month yield to maturity over 3.5%) to have created an attractive opportunity. Given a context of slowing economic growth and waning inflation indications, we have added weight in this and other lines of Canadas.

We also added weight in the 4% 2029 bonds of index provider MSCI Inc. (NYSE: MSCI). MSCI has demonstrated earnings resilience through a variety of economic cycles in the past two decades as customers have continued to subscribe to MSCI index offerings regardless of the prevailing market environment. With recent operating earnings covering interest charges more than six times and a one year default probability that we estimate at less than 0.1%, we found the 6% yield to maturity offered by MSCI 2029s to be attractive.

Fund Positioning

The Pender Corporate Bond Fund yield to maturity at June 30 was 8.5% with current yield of 5.7% and average duration of maturity-based instruments of 3.4 years. There is a 2.6% weight in distressed securities held for workout value whose notional yield is not included in the foregoing calculation. Cash represented 1.1% of the total portfolio at June 30.

Geoff Castle
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PenderFund Capital Management Ltd.