MARKET UPDATE – STATE OF CORPORATE BOND LIQUIDITY

For over 45 years, CIBC Asset Management has been a leader in fixed income management. During this time of market volatility, we commit to sharing some thought pieces to help our investors navigate these choppy waters.

Rebalancing a diversified portfolio

When significant market movements occur, there are opportunities to realign portfolio market weights with pre-established strategic policy guidelines. Over the long term, this activity naturally takes advantage of drawdowns and forces investors to dollar cost average. What is often overlooked is the effects large market disruptions have on the true market values of a fixed income portfolio. During extreme events, fixed income asset values may appear largely unchanged, but under the hood, government allocations may have rallied significantly and corporate credit allocations sold off. In addition, the actual trading environment and market prices are often only reflected in the index on a lagged basis.

In summary:

- The corporate bond market has seized up and typical mechanisms to source liquidity have broken down industry-wide
- Central banks around the world have begun in earnest to rectify these issues but more must and we believe will be done
- Until that time, selling into the corporate bond market will remain difficult and expensive
- Investors should strongly consider sourcing liquidity from other more liquid parts of their portfolio where possible until this market dislocation subsides

Market disruptions

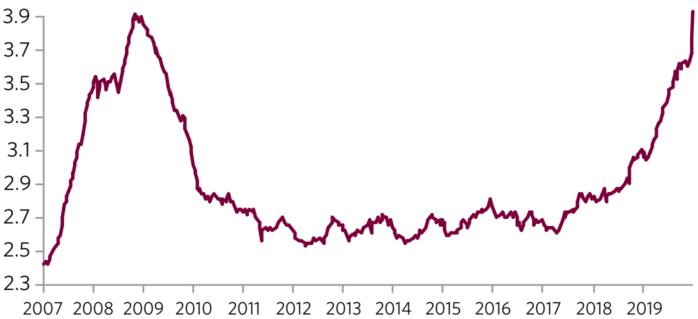
Economies and markets are experiencing a very significant shock. The impact of the COVID-19 virus outbreak has continued to shift from a China-centric demand shock, with important implications for global supply chains, to a more global economic and risk event. Adding fuel to the fire, an oil price war erupted in early March between two of the world's major oil superpowers, OPEC and Russia. This was due to a disagreement over future management of oil supply in a context of weakening demand caused by the coronavirus.

From a market perspective, the net result has been a significant increase in volatility, severe price dislocation, and some evidence of credit market stress associated with market concerns of a potential shortage in U.S. dollar liquidity. Financial markets have moved to price in a deep global demand shock, with an increasing likelihood of a global recession that persists well into the second half of 2020.

Set against this backdrop, fixed income markets are experiencing unprecedented levels of illiquidity. Market participants are fearful, dealer inventories have been shrinking ever since the Great Financial Crisis, and trading is skewed in one direction. In some ways, we are seeing a similar dislocation today in the credit markets as we did during the 2007-09 crisis but with a few key differences.

At the same time as corporate bond markets are stressed, investors are selling portfolio assets and moving into the safety of money market funds as shown in Exhibit 1.

Exhibit 1 – ICI all US money market funds total net assets (USD trillions)



Source: Bloomberg as of March 23, 2020

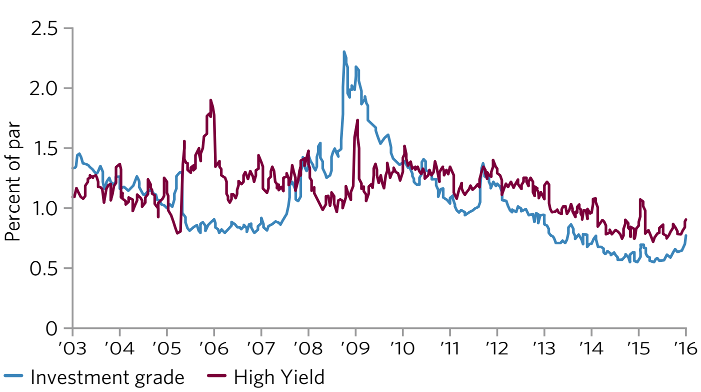
In this piece we outline the state of liquidity in the corporate bond market, how we're thinking through and managing the present challenges and why we believe moving from corporate bonds to money market and cash equivalents is not the best course of action at this juncture.

How does today compare to the credit crisis

Bonds unlike stocks, trade over-the-counter rather than on an exchange. This system works well during normal market conditions. However, during bouts of extreme market stress, investment dealers widen their bid-ask spreads given the lack of price transparency in an over-the-counter market. In addition, market sentiment is changing so rapidly even intra-day that inventorying bonds for short periods of time before finding a buyer can leave dealers exposed to large potential losses if the market moves quickly against them. As a result, bid-ask spreads as a percent of par value (face value of a newly issued bond) increases considerably during stressed periods as highlighted in Exhibit 2.

Although this is US data, we're seeing similar patterns in Canada with spreads as a percent of par at similar if not higher levels to the peaks experienced in 2008.

Exhibit 2 – US corporate bond bid-ask spread by credit rating



Source: Federal Reserve Bank of New York using TRACE and Mergent data.

What's different today

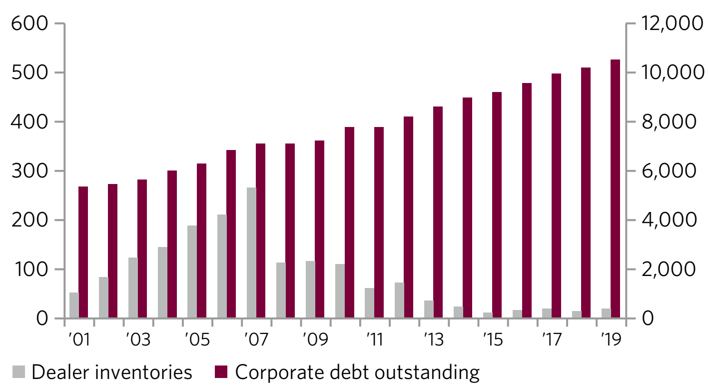
Dealer Inventories are no longer there to provide liquidity to the market

Pre-2008, dealers carried significant inventories on their balance sheet. This facilitated two-way trading at reasonable bid-ask spreads. After the Great Financial Crisis, regulatory frameworks such as the Volcker Rule were erected to limit proprietary trading by investment banks as well as raise capital requirements for dealers when holding bonds on their balance sheet. This ability to take on inventory when market participants are looking to sell in unison was an important release valve in times of market selloffs.

Now we find ourselves in a market structure where capital charges are high for dealers to hold corporate bonds and this is compounded by the broader macroeconomic concerns which is causing investment banks to hoard capital.

The dealers have much less desire to add to risk at these levels, so they are brokering bonds – meaning they will buy from market participants only when they find someone to sell to – resulting in more discounting of bonds to find a buyer. This lack of dealer support for corporate bonds comes at a time when low yields have influenced the rise of corporate debt outstanding.

Exhibit 3 – U.S. corporate debt outstanding and dealer inventories (USD billions)



Source: J.P Morgan Asset Management

What are Central Banks doing to help with liquidity constraints

This situation is developing as we write this, but policy authorities have implemented a number of significant policy initiatives in recent weeks, including over the past weekend (March 14-15). These included substantial reductions in policy interest rates, with a move to zero for the U.S. Federal Reserve and 75 basis points in Canada. In addition, central banks have substantially increased the amount of liquidity in the financial system, including via repos and central bank swap lines, corporate bond purchase facilities in some jurisdictions, and have eased bank capital and reserve requirement ratios. All these measures are intended to facilitate lending to the real economy, minimize the risk of funding shortages, and generally support the smooth functioning of markets during the current period of dislocation.

Looking at Canada in particular, there has been a flurry of measures from the Bank of Canada, the bank regulator, and the government to support the functioning of credit markets. These include a backstop for the Bankers Acceptance market which is a critical tool businesses use for short-term funding and support for bank funding through an insured mortgage purchase program amongst other measures.

The one thing that Bank of Canada has not done to date unlike the other major central banks around the world is launch a new round of Quantitative Easing. However, there is chatter this may be coming and the Bank could even buy spread product, including corporate debt, to target those efforts at segments that might need it. This would be an unprecedented and constructive move by the Bank and supportive of the corporate bond market.

What we are doing to manage this

1. For funds that have a government allocation, liquidity is being sourced through non-corporate securities wherever possible

We are selling Government of Canada and to a lesser extent provincial bonds in these funds to limit the selling of corporate bonds at sharp discounts. While this organically increases the credit exposure in our funds, right now, this is consistent with our strategic sector position views and the investors can benefit from an eventual recovery in corporate bonds.

2. Less electronic trading

Electronic trading platforms are generally quick and efficient to facilitate trading during normal market environments. However, in these times of market stress we are doing almost all corporate bond trading over the phone, directly with sell side traders. In this way, we can give the dealer some indication (within reason) of the size and type of securities we need to move and they'll work the order for us over time rather than them having to bid up front for our bonds against other dealers.

By giving them time rather using an electronic system which uses an auction format, dealers aren't forced to mark the prices out in a punitive manner because of the uncertainty whether they can find a buyer on the other side of the trade; instead they have time to source buyers and digest the order which ultimately improves pricing. This becomes especially more effective in the case of CIBC AM, given our firm's large presence in the Canadian market and strong relationships with dealers; we believe the dealers will go to greater lengths to fulfill our orders and at better prices than they would smaller players in the market.

3. Cross trades

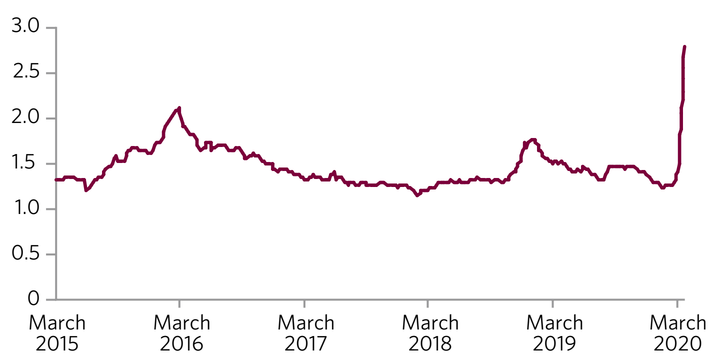
A cross trade is when an asset manager has one fund that wishes to purchase a security and another fund that wants to sell that same security. Rather than going through an investment dealer who will intermediate for a price, a cross trade eliminates this dealer involvement while achieving the same result for clients of each fund.

We have detailed procedures that must be adhered with independent checks done outside the portfolio management process. In summary though, pricing is based on the index closing price for the day to provide a transparent, independent source of pricing and ensure fairness amongst investors.

We have taken steps to provide liquidity to corporate bond mandates via other strategies that we manage. For example, universe mandates cross trade away government securities which have rallied recently and receive corporate bonds to increase credit risk after spreads have widened. Corporate mandates cross trade away corporate bonds at prices that don't include punitive investment dealer bid-ask spreads while receiving government bonds which can be used to generate liquidity as needed.

For context, current credit spreads are at levels only seen three times in this cycle and are above those levels that prevailed during the 2011 Greece crisis and the 2015/16 episode where oil went into the $20s as shown in Exhibit 4.

Exhibit 4 – Mid Canadian corporate spreads



Source: CIBC Asset Management Inc. and FTSE Debt Capital Markets as of March 23, 2020

Why selling in today's market is not ideal

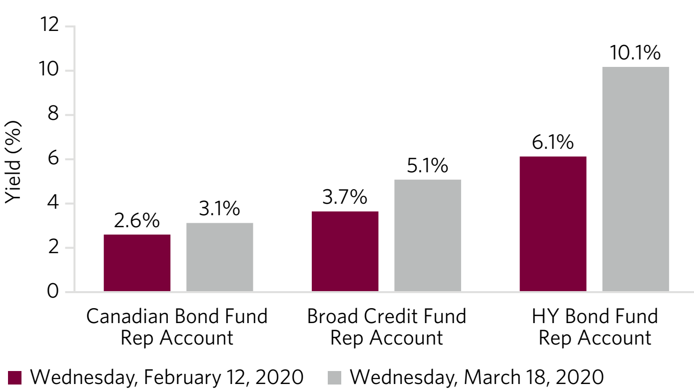
Higher bid-ask spreads:

Investment dealers are market makers that typically stand ready to buy and sell securities with market participants. In this time of uncertainty, where investment dealers want to limit the amount of capital deployed and prices are moving around so violently day-to-day, pricing offered by investment dealers can be highly punitive to sellers. We are seeing dealer quotes $4-6 wider than the index has them marked. Take a hypothetical corporate bond that is marked in the index at $100. Dealer pricing amounts to sellers having to take a 4-6% haircut to source liquidity – that's an unprecedented haircut!

Increased portfolio yields:

As bond prices and yields are inversely related, the recent selloff in corporate bonds has made the yield of corporate bond funds more attractive. While there is likely more turbulence to come and we're not backing up the truck to add credit exposure just yet, yields are starting to move towards attractive levels – that's not the dynamic in which value-conscious investors want to be selling into. Instead, look to government allocations, money market, GIC's and other deposits to source liquidity and/or create room for rebalancing.

Exhibit 5 – Yields enhanced (%)

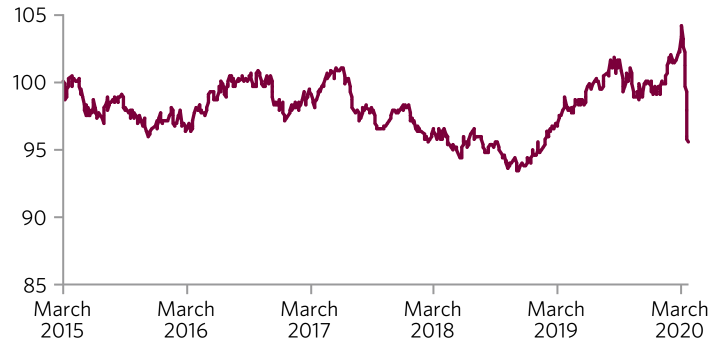


Source: CIBC Asset Management Inc.

Selling at price lows for corporate bonds?

Bonds prices are at nearly the lowest levels over the past five years. However, the rapidity of this drop has been unprecedented – the mid corporate bond index has seen prices drop 8.2% between March 6, 2020 and March 23, 2020 and are only 2% off the 5-year lows from Q4 2018. Under the old adage of buy low, sell high, one has to question whether selling an asset class after such a brief but substantial selloff is ideal.

Exhibit 6 – Mid Canadian corporate bond prices



Source: FTSE Debt Capital Markets as of March 23, 2020

Conclusion

We understand that a fixed income allocation is typically a relatively liquid portion of a portfolio and is often one of the first asset classes people look to reduce when conducting a portfolio rebalance after equities have sharply sold-off. However, these aren't typical times and atypical measures are advisable to better navigate this environment. As such, we are recommending against liquidating corporate bond funds in favor of rebalancing with money market holdings, GICs, and other deposit accounts as a means of avoiding capital losses in client fixed income portfolios.

Fixed income funds that hold more government bonds could also be considered for liquidation to provide funds for equities, given they have performed relatively well as seen by their yields having barely increased since year-end.

Yields on corporate heavy bond funds are looking increasingly attractive, making this the time to hold these funds wherever possible for their stabilizing qualities and income distributions over the long term.

We believe government policy initiatives will likely improve the liquidity of corporate bonds in the coming weeks. As these policies are implemented and begin filtering through the financial system, some of the current dislocations and lack of liquidity in the markets should abet. This in turn should provide more price transparency to the market and an ability to trade corporate bonds at fairer levels.

Should you have any concerns or questions, please do not hesitate to contact the Client Portfolio Management team at DLCAMClientPortfolioManagers@cibc.com or Carlo DiLalla, Kevin Minas, or Ebad Saif directly.