Corporate bond spreads, otherwise known as credit spreads, are an important measure of risk, liquidity and general market conditions. Credit spreads widen when market participants favor government bonds over corporate bonds, typically when economic conditions are expected to deteriorate. In 2018 credit spreads widened globally and reached a two year high on investor expectation of a slowdown in economic growth. This widening created an opportunity for TD Asset Management (TDAM) and our clients.

This paper highlights TDAM's Active Fixed Income Strategy, focusing on our credit research capabilities and our analysis of compensation for risk.
The recent widening of credit spreads is a market occurrence that TDAM has navigated in the past. We have consistently utilized our credit and market expertise to determine if these occurrences are due to a deterioration in credit markets or attributable to systematic risk events. To fully discuss the efficacy of our Active Fixed Income Strategy, a retrospective look at the performance of the strategy before, during and after periods of credit spread widening is required. Chart 1 below compares Canadian Investment Grade Corporate Bond Spreads with the rolling excess returns of TDAM’s flagship core fixed income strategy.²

**Chart 1: Credit Spread Widening Opportunities**

Data as of March 2019. Source: TDAM Internal, Bloomberg Financial L.P.

Contrasting TDAM’s Investment Process with the Developments in Canadian Investment Grade Corporate Spreads

Since the 1990’s TDAM has applied the same disciplined and repeatable process to analyzing credit spread widening opportunities and positioning our fixed income portfolio to benefit from their occurrence. As illustrated in Chart 1, by using this investment process, we have continually been able to generate long-term excess returns for our clients.

A qualitative review of our fixed income strategy Pre-And-During the 2008/2009 Financial Crisis illustrates this in more detail. As indicated in Chart 1, the most prominent event over this time period is the 2008-2009 Great Financial Crisis (GFC). However, there were other notable periods of credit spread widening that occurred both before and after the GFC that allow us to take an in-depth look at the investment decisions we made.

**Pre-and-During the Financial Crisis (1999-2009)**

From 1999 to 2007, major credit spread widening opportunities were scarce. Investment grade credit spreads ranged between 50 to 100 basis points (bps) for Canada and 60 to 200 bps for the United States. However, market events such as the Dot-Com Bubble, the 9/11 Attacks and the two infamous accounting scandals of Enron and WorldCom, contributed to increases in credit spreads. Conversely, the credit spread tameness that was present in the late 90’s and early 00’s was non-existent during 2008/2009. During this period, credit spreads widened significantly due to heightened uncertainty and a growing concern about the ability of corporate (and other private) borrowers to service their debt amidst deteriorating economic conditions.

²Excess returns are the performance differential of TDAM Core Fixed Income Strategy minus the FTSE Universe Bond Index.
During the abovementioned periods and throughout all cycles, we utilized our macroeconomic expertise to understand why spreads were widening and where opportunity resided in each sector. During this time, our portfolio managers significantly overweighted those securities approved by our credit research team and believed to provide the best compensation for taking on risk.

Following each credit widening period, as credit spreads began to normalize, TDAM delivered significant returns to its clients.

**Post Financial Crisis (2010-Present)**

In the post-Financial Crisis market environment, credit spreads have remained above their historical averages due to market moving events such as, Black Monday, Standard & Poor’s downgrade of the United States sovereign debt, the end of the quantitative easing (QE) program, Brexit and the United States presidential elections.

Similar to previous credit spread widening periods, as credit spreads began to normalize, our clients benefited from strong outperformance.

In 2013, we began to decrease our overweight corporate bond exposure due to tighter credit spreads and reduced compensation for risk. We noted the steady deterioration of various corporate balance sheets and income statements, and viewed this as an inflection point in the credit cycle where default risk was likely to rise in the near term. By 2015, our overweight position in investment grade corporate bonds was near its lowest levels (see Chart 2). This was a well-timed investment call that allowed us to be well positioned to protect our client’s assets, as the weakening of the economic outlook in 2016 caused spreads to widen materially.

As credit spreads widened in 2016, we once again increased our overweight position in corporate credit. However, we did not increase this allocation to the same extent we had done historically. Our more cautious approach was driven by the view that corporate credit performance would continue to deteriorate against a backdrop of weakening economic conditions, weaker measures of corporate balance sheet health, profit growth, and increased market volatility and uncertainty.

**Chart 2: Overall Historical Corporate Bond Exposure**

Data as of March 2019.
Source: TDAM Internal, Bloomberg Financial L.P.
However, although our methodology over this period was both sound and consistent, the market recovered more quickly than anticipated and we experienced a more modest outperformance relative to the benchmark than in previous periods.

Since the beginning of 2018, the rise in macroeconomic uncertainty globally has contributed to the widening of credit spreads. This has once again presented us with an opportunity to assess and capitalize on credit mispricing available within select corporate bond sectors and issuers.

We believe this is a timely opportunity to increase our overweight allocation to investment grade credit and the rationale behind this decision is threefold, which we detail below.

### Rationale 1

In conjunction with corporate bond spreads widening, investment grade corporate credit spreads have recently become very attractive, given where we are in the current economic cycle. A deconstruction of the Canadian and U.S. yield curves, reveals that we are likely in the later stages of the cycle and will remain there for the time being. We currently do not expect a recession to materialize this year and believe the likelihood of this occurrence in the near future to be low. This view is supported by the levels of industrial production (Chart 3) and consumer sentiment (Chart 4) which are near recent highs, as well as the historically low global unemployment. In addition, despite global GDP growth slowing, it remains stable as economies continue to demonstrate resilience.

In comparison to past economic cycles, the current credit spreads look appealing and are on average 40 bps to 50 bps wider than where they should be.
Rationale 2
Non-financial corporate profits grew at a significant pace in 2018 (see Chart 5). This rate of growth may not occur in 2019 due to expected softening in business sales, industrial production and manufacturing from previous peak levels. For corporate debtholders, the stabilizing profits will likely be offset by slower debt growth over the remainder of this year and potentially next year. A slowing corporate debt growth rate may be an indication that corporate default rates will remain stable.

Chart 5: Corporate Profits & Cash Flow

Data as of March 2019
Source: TDAM Internal, Bloomberg Financial L.P.

Rationale 3
Recently, the Federal Reserve and the Bank of Canada have moved away from a hawkish monetary policy stance, which would have raised interest rates during macroeconomic uncertainty and impacted the economy adversely. The more dovish stance adopted by these central banks is likely to have a positive impact, as the risk of policy error is significantly reduced. The lower for longer interest rate environment is expected to persist given the low level of inflation (see Chart 7) and unemployment.

Chart 6: Global Overnight Rates

Source: TD Asset Management, Bloomberg Finance L.P. As of March 31, 2019
Portfolio positioning based on the rationales stated above

As the spread between BBB and A-rated credit widened in the second half of 2018, we have increased our exposure to corporate bonds and are taking advantage of mispricing opportunities in the BBB-rated space. We took advantage of this opportunity for the following reason – as the leverage within the BBB-rated space between 2015 and 2018 was primarily driven by a wave of Mergers & Acquisitions activity, low interest rates and the small spread differential between A and BBB issuers, we are expecting a reversal in this leveraging trend in 2019. In analyzing the fundamental data and conducting bottom-up research, we observed that BBB-rated corporate issuers are now beginning to address their balance sheets more proactively and focus on de-leveraging. Because of their strong commitment to bondholders, the majority of these companies are seeking to improve their leverage profiles which will be a supportive factor for credit quality. Given all the above factors, we believe that many attractive BBB opportunities exist, however, we remain focused on investing in quality issuers with solid business fundamentals, greater financial flexibility and management teams with strong commitment to their bondholders.

Chart 8: Corporate BBB Exposure Relative to Benchmark

TDAM Active Fixed Income Strategy relative to the benchmark, FTSE Canada Universe Bond Index.
As of March 31, 2019
Given we are in the later stages of the economic cycle we are also paying particular attention to credit volatility. Our overweight exposure is focused on the less volatile sectors such as Financials and Telecommunications (see Chart 9).

Chart 9: TDAM Sector Volatility Score

Data as of March 2019
Source: TDAM Internal, Bloomberg Financial L.P.

To assess credit volatility, we employ a proprietary credit scoring model based on key financial ratios and metrics indicative of an issuer’s credit quality over time. Our credit analysts then compare the issuer’s credit volatility against a broad universe of investable investment grade issuers to assign a Risk Score between 1 (least risky) and 10 (most risky).

The model output provides the portfolio management team with a relative measure of financial metric volatility used in selecting issuers and sectors with a lower volatility score.

Chart 10: TDAM’s Credit Rating and Risk Scoring Model

For illustrative purposes only.
Conclusion

TDAM's active fundamental fixed income philosophy and investment process are built on our institutional capabilities in macroeconomic analysis, credit research and in-depth yield and credit curve analysis. As detailed in this paper, the methodology behind TDAM Active Fixed Income Strategy has proven to be sound over varying periods of credit spread widening which has resulted in a long-term added value for our clients.

TDAM utilizes a disciplined team-based approach to deliver investment excellence for our clients. Our portfolio management process is supported by one of Canada's largest fixed income teams, which consists of over 60 fixed income investment professionals. This breadth of fixed income expertise allows us to better manage risk, stress test our analytical models and dynamically manage our client's portfolios for potential vulnerabilities, such as interest rate and/or credit shock scenarios. Through our collective effort, we strive to smoothly navigate multiple market cycles to the benefit of our clients.