Market Overview

Over the past couple of weeks, it appears that we have started transitioning into a new phase of market dynamics with respect to COVID-19. As we anticipated for late April, recent data has revealed that North America may be nearing peak cases, although we are continuing to see significant regional disparities. While this doesn't signal an imminent return to normalcy, policy discussions are beginning around a path to re-opening economies.

Overall, equity markets have held most of their gains from the late March lows, but momentum appears to be waning. Breadth is narrow with a few large cap companies leading the way and trading volumes are lower than prior weeks. Additionally, oil prices provided the latest unprecedented shock, with May futures contracts trading at a negative value, implying that holders of these contracts had to pay buyers to take their positions. I cover this historically unusual phenomenon in greater context in my equities commentary below.

These factors combined point to the potential for near-term weakness or at least a period of consolidation. Near term, we are tactically positioning portfolios with a neutral equity weight, an underweight in universe bonds, and a modest cash overweight. This provides us with the agility to respond defensively to volatility driven by economic uncertainty and allows us to increase exposures in response to positive developments on virus containment. For longer term target allocations, our counsel to many investors is to continue maintaining a strategic direction versus initiating material shifts in policy weights.
Asset Class Overview and Outlook

Equities

Last week investors witnessed historic events taking place in the energy markets. The dramatic collapse in oil prices for physical delivery in May were driven largely by the dynamics of how futures contracts are settled. For those investors that held long positions in the May contract, they would have been obligated to take physical delivery at a time when storage is reaching maximum capacity, and costs to do so are extremely high. With no new buyers willing to get involved in this toxic transaction, contract holders were left with no choice but to sell at any cost including the unique situation where they were forced to pay buyers to take the oil off their hands. This was technical in nature, as futures contracts are settled with physical delivery of the commodity. Energy stocks were weaker on the news but did not significantly deviate from overall market weakness during the week. However, it does shine a light on how COVID-19 is impacting oil prices in the interim. With the immediate (and immense) downward impact on demand, the supply side of the equation may potentially need to see further contraction to reach equilibrium. Until then, oil price volatility is expected to remain high. Announced OPEC plus cuts of 10 mbd or roughly 10% of supply were met initially with a rally in oil markets until realization that it simply would not be enough. Demand destruction has far exceeded the OPEC cuts as travel has been decimated and industrial demand had dropped considerably.

Despite last week’s continued volatility, the overall performance of global stock markets has been on an upward trajectory since the lows posted on March 23. This is perhaps a sign of positive advancement in terms of containment and evidence that social isolation policies are starting to work in Europe and North America. Monetary and fiscal responses have also helped soften the overall impact of the global shutdown. Though progress is being made, further consensus seems to be growing around a sharp impact to global economies in Q2-2020, with year-over-year numbers negative for some time, and the pace of recovery highly uncertain. The impact on 2020 earnings growth remains fluid, with estimate revisions continuing to be negatively skewed and the vast majority of companies abandoning any form of guidance. As a result, equity volatility may remain elevated for an extended period.

Alternative Assets

A major consequence of the pandemic is the substantial decline in oil demand across the world. Due to stay-at-home and physical distancing measures, it is unclear how long demand, and in turn oil prices, remain at depressed levels. For energy-dependant markets, COVID-19 is magnifying the economic challenges facing different cities and regions. Within Canada, although there are initiatives attempting to diversify its local economies, Alberta remains the energy hub. The Calgary and Edmonton office markets were already experiencing higher vacancy levels and lower net rental rates from the previous energy crisis, which was compounded by oversupply of new office space. The pandemic is expected to put further pressure on office fundamentals in Alberta. It remains to be seen how the targeted government stimulus programs may help navigate these additional headwinds. Despite weaker office fundamentals in Alberta, we have yet to witness major distressed selling given the concentration of well-capitalized institutional real estate owners.
Our real estate and commercial mortgage portfolio is broadly diversified across Canada. Within Alberta, the portfolios own or lend across all sectors including office, retail, industrial and multi-unit residential properties. The real estate strategy owns, what we believe are high quality, transit-linked office assets in Calgary and Edmonton with diversified in-place tenancies (e.g. government, technology) that are expected to provide better positioning if a flight-to-quality intensifies. While office assets have experienced unrealized capital losses due to market conditions, the assets continue to generate positive income streams. Moreover, the majority of our Alberta real estate allocation is in multi-family, industrial and grocery-anchored retail assets that tend to be less correlated to energy prices. Within the commercial mortgage portfolio, our loans in Alberta continue to demonstrate stable and predictable income. Our borrowers are large institutional real estate operators with long term investment horizons. Furthermore, the quality of underlying real estate, prudent underwriting, and additional lender recourse are key risk mitigants providing protection during the energy turmoil.

Fixed income

Fixed income markets have remained on stable ground through the first few weeks of April, reflecting meaningfully improved investor sentiment across markets. April has brought additional aggressive fiscal and monetary measures, which seemingly increase in size and scope each week. The combination of the pledged support by political institutions and central banks, when combined with greater visibility of a potential re-opening of global economies, has led to a continuous improvement in market functionality.

In the month of April, we have seen relative levels of volatility in the fixed income markets come down meaningfully. One example of this can be found in the rates market, where Government of Canada bonds have exhibited much greater stability. For context, in March 10-year Government of Canada bonds started the month at a yield of 1.10%, before falling to 0.54% by the 9th of the month, to double just 9 days later back to the 1.10% level, before finishing the month at 0.76%. This represented a range of 56 basis points (bps) over the month. In April, yields have settled in between 0.60% and 0.82%, representing a range of just 22 bps.

This week we can report that corporate credit markets in Canada have continued to improve, driven by the recently announced efforts by the Bank of Canada to support the corporate and provincial sectors. Since the announcement of the Provincial Bond Purchase Program and the Corporate Bond Purchase Program on April 15, Canadian provincials and investment grade corporates have continued to grind tighter.

As we have been speaking about for some time, TDAM’s fixed income teams have been actively increasing allocations to corporate credit, given what we believe is the relative attractiveness of the asset class following the significant sell off in March. In Canada, just over 21% of the investment grade credit universe is dominated by Energy related credits, a relatively large number if we compare to the United States market where just under 8% of the market has exposure to the energy sector. Given this market dynamic and the weakness exhibited in crude oil prices over the last few months, we wanted to provide some insight on the sector.

The weakness in crude has clearly led to the underperformance of energy related credits, as energy spreads nearly doubled in March, widening by 155 bps. Our credit research team has been diligently tracking the effects of a lower price environment on energy related credits and has provided our portfolio managers with additional resources to properly price the credit risk in the market. In this work, our team has taken action to downgrade several credits that will experience weaker fundamentals going
forward, though at this time we note that very few credits in our coverage are being projected to have metrics that no longer align with an investment grade credit rating. In addition, our teams continue to uncover value in certain energy sub-sectors, like pipelines for example. Pipelines in our opinion are the safest sub-sector of the energy related segment, as most of the credits we invest in have strong contractual structures that limit cash flow variability. In short, while the sector is clearly under pressure we believe that dislocations can still exist, and our teams are working in collaboration to position our exposure in the sector for the best potential outcomes for investors.

Should you have any questions related to your portfolio, please reach out to your Relationship Manager.

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