BROMPTON FUNDS

Brompton Insights

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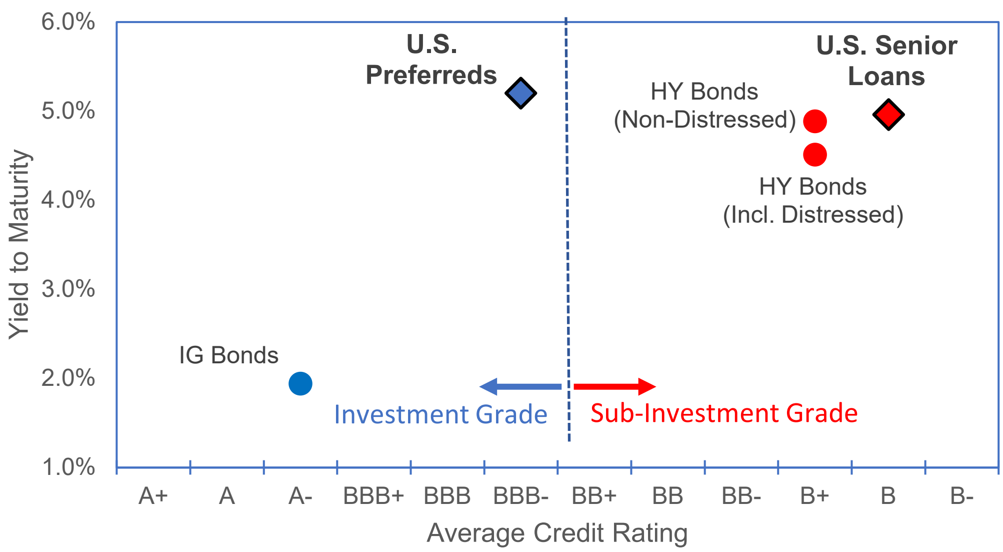
The Search for Yield Continues

Fund in focus: BPRF – Brompton Flaherty & Crumrine Investment Grade Preferred ETF
SSF.UN – Symphony Floating Rate Senior Loan Fund

In our August 2020 edition of Brompton Insights, we discussed how investors are faced with the challenge of finding income in a low-rate, deteriorating-credit world. Today it's even more challenging for US corporate bond investors to find an appropriate level of yield for the risks assumed.

The US Federal Reserve believes US companies face heightened insolvency risk. According to the Federal Reserve's February 19, 2021 Monetary Policy Report: "Business debt has risen from levels that were already elevated before the outbreak of the pandemic. Business leverage now stands near historical highs, insolvency risks at small and medium-sized firms, as well as at some large firms, remain considerable." Typical High-Yield ("HY") issuers straddle the medium-to-large company category, so this comment gives us cause for concern. In fact, the combination of high leverage and difficult business conditions during the COVID-19 pandemic appears to have continued the long-term deterioration of credit for HY issuers in the US. Since we last wrote on these topics in August 2020, we note that the average credit rating for HY issuers in the US has declined from BB- to B+, one "notch" lower on the rating scale.[1]

U.S. Preferreds & Senior Loans – Attractive Yields[2]



Fed support for trading prices in the US Corporate Bond market has ended. The Secondary Market Corporate Credit Facility ("SMCCF"), which was established to support market prices for US Corporate Bonds through open market purchase of Investment Grade ("IG") and certain HY bonds and ETFs, was wound down along with several other programs on December 31, 2020, and the US Treasury requested the return of its $429B capital. Undoubtedly the US Treasury would act again in some capacity to support capital markets should there be further disruption, but given the program is now no longer active this would likely be AFTER trading prices weakened. For now, the "safety net" that the SMCCF represented for HY and IG bond investors has been removed, putting trading price risk for HY and IG bond prices squarely back on investors.

US inflation risk, and by extension the ongoing risk of rising interest rates, continue to increase. As former Treasury Secretary and Harvard Professor Lawrence Summers pointed out in a recent op-ed in the Washington Post[3], President Biden's proposed $1.9 trillion stimulus package is at least 3 times the size of the "output gap" for the US economy. If this package is approved, this argument points out that the increased demand for goods and services from US consumers could be larger than available production capacity. If realized, this scenario would result in demand-pull inflation, which could be reflected in rising interest rates. Rising rates will negatively impact prices for HY bonds but could have an even greater negative impact on lower-yielding IG corporate bonds.

Corporate bond yields have compressed significantly over the past year. HY bond, IG bond and ETF buying through the end of 2020 has resulted in lower yields, especially for HY bonds. Lower yields leave very little cushion to absorb losses due to credit defaults and rising interest rates. The yield curve has recently steepened significantly with the US 10-year treasury yield now over 1.5%.[4] Fixed rate bonds have begun to respond by trading lower as the yield curve steepens; if long-term interest rates continue to increase, losses for corporate bond investors may continue.

For HY investors, US Preferreds or Senior Loans can help to mitigate these risks. In terms of interest rate risk, both Senior Loans and US Preferreds provide comparable yields to HY bonds, providing a level of protection against the risk of inflation and rising interest rates. Loans offer floating-rate coupons which provide the opportunity to reset coupons higher as short-term rates move up due to inflation/economic recovery. Similarly, most US Preferreds have coupons that are either currently floating or are scheduled to begin floating within the next few years, providing interest rate protection to investors. And further, US Preferred issuers are concentrated in the financial sector (banks and insurance companies) which stand to benefit from stronger growth and a steeper yield curve. Such a scenario could lead to narrower credit spreads for Preferreds from these issuers.

Like HY bonds, Senior Loans are rated below-investment-grade, however they rank senior to HY bonds in a company's capital structure and are secured by assets of the company, generally providing greater protection to investors in the event of a default. US Preferreds are IG credit quality on average, with historical default rates that are much closer to IG corporate default rates than to HY default rates. Both Senior Loans and US Preferreds offer yields that are more than double that available from US IG bonds, compensating investors attractively for the level of risk assumed.

Brompton Flaherty & Crumrine Investment Grade Preferred ETF (TSX - BPRF, BPRF.U) offers investors a way to invest in the US Preferred share market with the benefit of active management by the longest-tenured US preferred share specialist, Flaherty & Crumrine Incorporated.

Symphony Floating Rate Senior Loan Fund (TSX - SSF.UN) offers investors a way to invest in an actively managed portfolio consisting primarily of short-duration floating rate senior corporate instruments managed by specialists Nuveen Asset Management, LLC.

1) Refinitiv Datastream as at August 19, 2020 and January 31, 2021.

2) Credit Suisse, Refinitiv Datastream, as at January 31, 2021. "IG Bonds" represents ICE BofA U.S. Corporate Bond Index; "HY Bonds (Incl. Distressed)" represents ICE BofA US High Yield Bond Index; "HY Bonds (Non-Distressed)" represents ICE BofA U.S. Non-Distressed High Yield Bond Index; "US Preferreds" represents ICE BofA 8% Core West Preferred & Jr. Subordinated Securities Index; "Senior Loans" represents Credit Suisse Leveraged Loan Index.

3) https://www.washingtonpost.com/opinions/2021/02/04/larry-summers-biden-covid-stimulus/

4) Refinitiv Datastream as at February 26, 2021.

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