AGF INVESTMENTS

AGF MARKET INSIGHT

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Where are we in the credit cycle? Lessons from history and implications for the future

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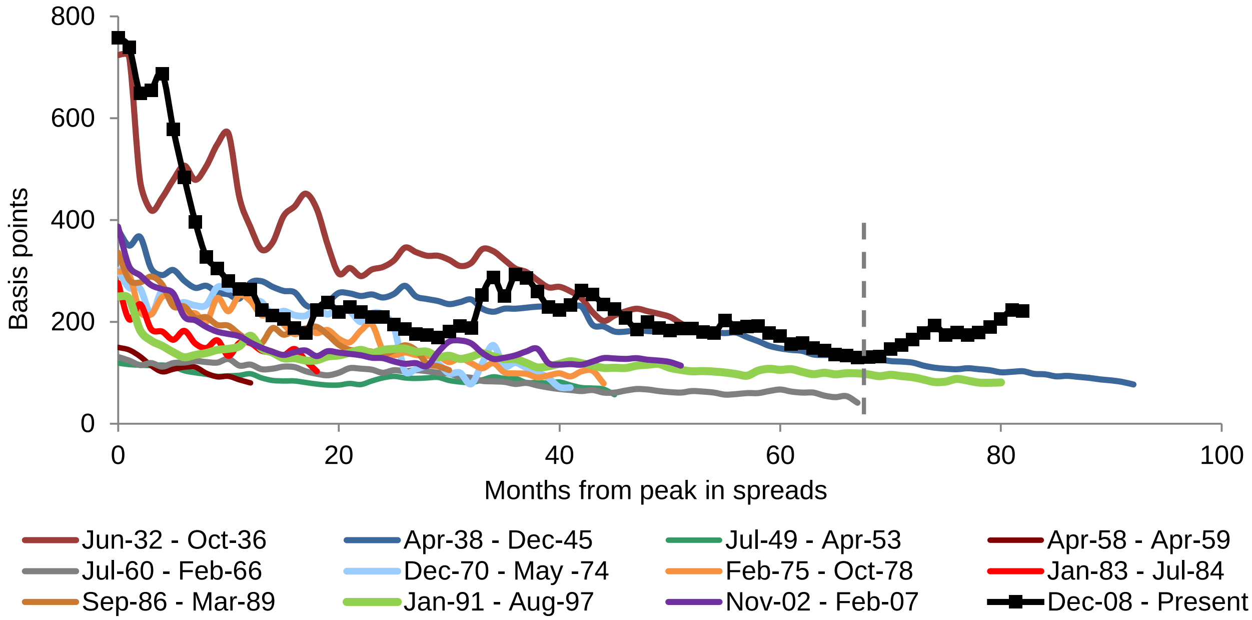
POST-FINANCIAL-CRISIS ERA

The financial crisis of 2008 precipitated a credit-induced recession in North America that resulted in a meaningful slowdown in aggregate consumption and investment. Unprecedented levels of household financial leverage eventually caused a spectacular collapse of asset prices, the impact of which wasn't simply disinflationary but outright deflationary. It laid the foundations for what proved to be a stellar six-year period for corporate credit, after credit spreads over government bond yields peaked in December of 2008. For the six-year period ended December 2014, the Merrill Lynch U.S. High Yield Index returned a CAGR of 15.8%, which compares well to the S&P 500 Index's return of 17.2% over the same time period.

In recent months, there have been increasing warnings about a potential bubble brewing in the credit markets. Investors have been concerned about a possible spillover from the oil-induced declines of the Energy sector to the overall market resulting in a full-blown sell-off. Our analysis leads us to the conclusion that economic fundamentals are adequate enough and corporate fundamentals are strong enough for several more years of credit outperformance. However, we are also mindful of the fact that, notwithstanding our bullish view on credit, we are certainly in the later innings of the credit cycle and hence do not expect to repeat aggregate returns of the last six years. Notwithstanding the fact that this bull market has been one of the longest in the last 85 years, credit cycles don't typically die of old age.

Figure 1: Credit bull markets (1930-present) – BBB spreads

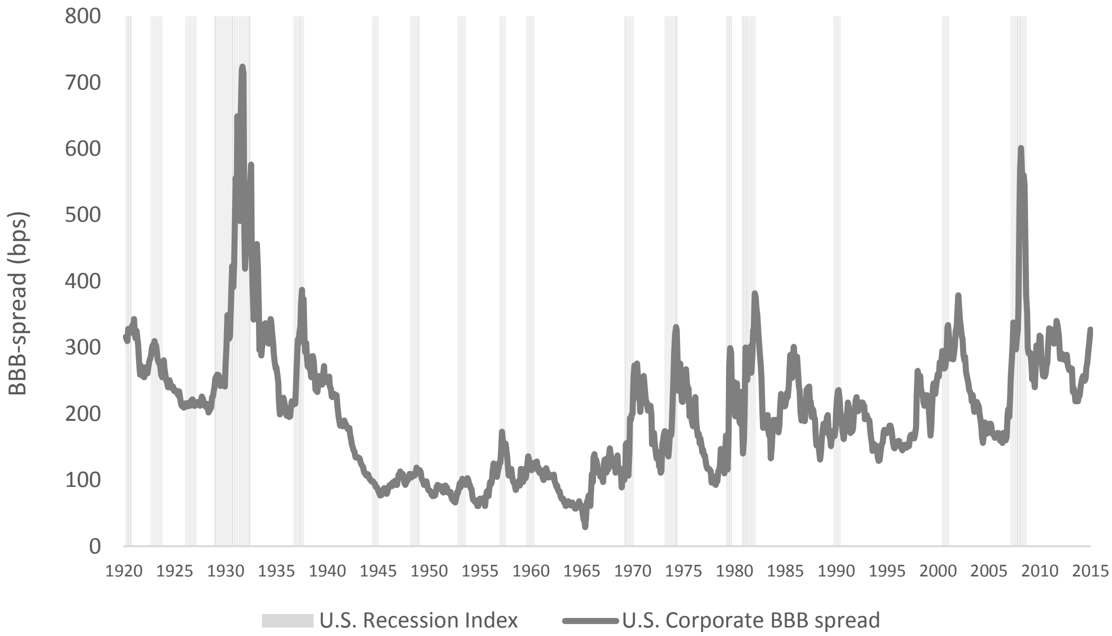


Sources: Bloomberg, U.S. Federal Reserve Board.

BASE CASE = NO RECESSION

If history is any guide, recessions that are caused by bursting asset bubbles result in shallow economic recoveries that take years to work out. Looking back, the Swedish and Finnish banking crises of the 1990s as well as the Japanese real estate crisis are ideal examples where the recovery trajectory remains very gradual. We do not predict a recession in North America for the foreseeable future because we lack the economic excesses that tend to build up prior to a recession. These include substantial interest rate tightening as a result of an over-heated economy, an oil price shock (e.g. prices spike) and/or an overly heated credit market as a result of a surge in capital expenditure driving inventory accumulation, which in turn would drive leverage ratios to tick up and cause credit spreads to spike. The U.S. economy has averaged roughly 2.1% annual real GDP growth over the last six years, a figure that historically has not indicated that material economic imbalances exist. Other metrics such as inflation, manufacturing, personal consumption and industrial production argue for the same. This all bodes well for credit. Looking back through 100 years of history, absent a recession, corporate spreads generally remain in a tightening trend (Figure 2).

Figure 2: Speculative-grade default cycles



Source: Bloomberg, U.S. Federal Reserve Board. Monthly data series to October 31, 2015. Shaded lines are NBER defined recessions.

LOWER FOR LONGER – THE SEARCH FOR YIELD CONTINUES

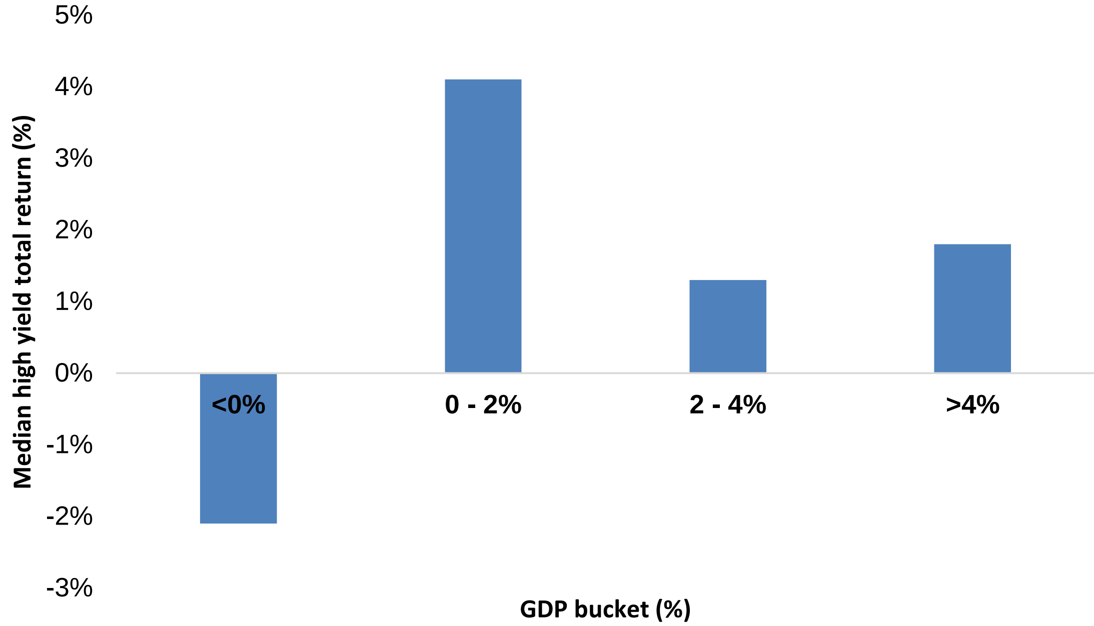
We have long maintained the view that interest rates, although at generational lows, will continue to stay low for the coming years. Notwithstanding the odd cyclical bear market, like the one in 2013 that may result in yields spiking temporarily, the current economic backdrop argues for a tepid interest rate environment as total debt levels in the economy continue to grow[1]. Such a benign interest rate environment continues to be conducive for credit in two ways:

1. **Sub-optimal economic growth is favourable for credit performance**
   Corporations struggle to perform in a recession since the demand for their goods and services drops. Additionally, lack of demand results in lack of investment, resulting in stretched balance sheets and anemic or negative EBITDA growth. Net-net, the result is weak or even negative credit returns and wider spreads. Conversely, strong economic growth is symptomatic of an inflationary economy where credit may initially perform as a result of improving corporate fundamentals but eventually rising revenue growth will not be able to keep up with rising input and borrowing costs. As Figure 3 demonstrates, credit thrives when growth is neither too anemic to cause recessionary pressures or too hot for inflation to ramp up. A low growth environment is ideal for credit since borrowing costs remain low, inflationary pressures remain muted and EBITDA growth is generally adequate for a

[1] To read more about our secular view, read *Lower for Longer: History tells us that interest rates are likely to stay low*: http://www.agf.com/institutional/global-resources/files/market-insight/agf-market-insight-lower-for-longer-en.pdf

company to grow into its balance sheet. We believe that growth will be stuck in this muddle-through phase for the coming quarters and remain largely supportive of credit performance.

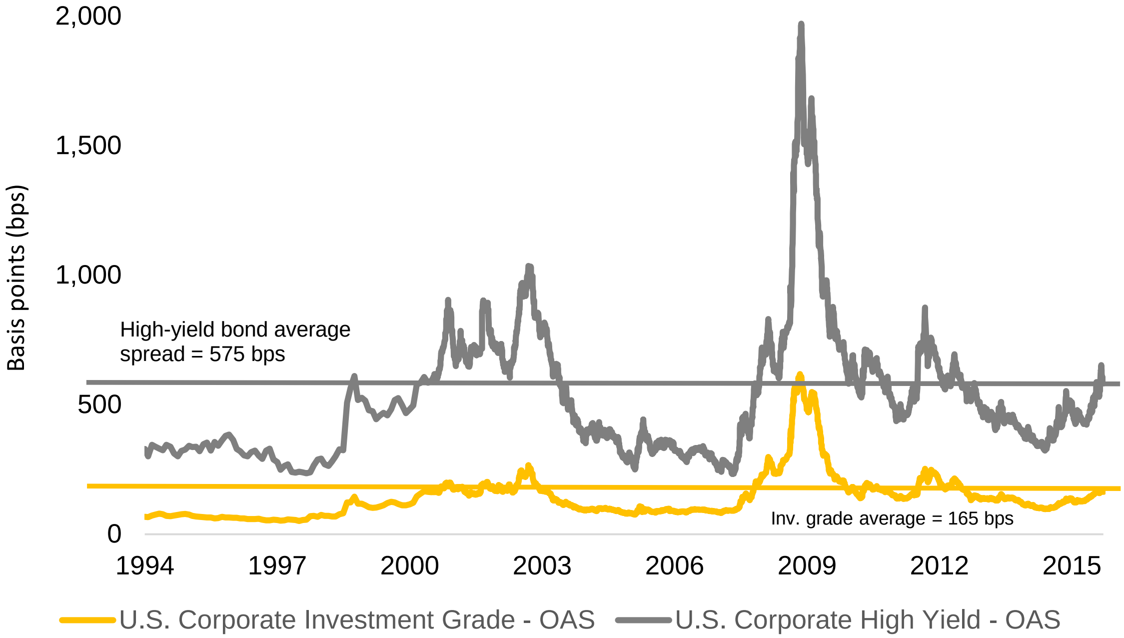
Figure 3: Median high-yield total return by GDP bucket



Source: Bloomberg.

2. **Corporate credit provides attractive yield opportunities vs. government bonds**
Relative to traditional government bond yields, corporate credit continues to look attractive (see Figure 4). The recent widening of credit spreads in investment-grade and high-yield markets has brought overall spread levels above historical averages, a level not seen since 2011. On September 30, 2015, the U.S. investment-grade spreads reached a high of 169 basis points, higher than the long-term average of 159 basis points. The U.S. high-yield market posted a spread level of 631 basis points, well above the long-term average of 561 basis points. At such levels, not only would investors earn a handsome yield (high yield now delivers a 7.5% yield and investment grade delivers close to 3.5%), but any modest tightening of spreads could also result in attractive total returns.

Figure 4: U.S. investment-grade and high-yield bond spreads



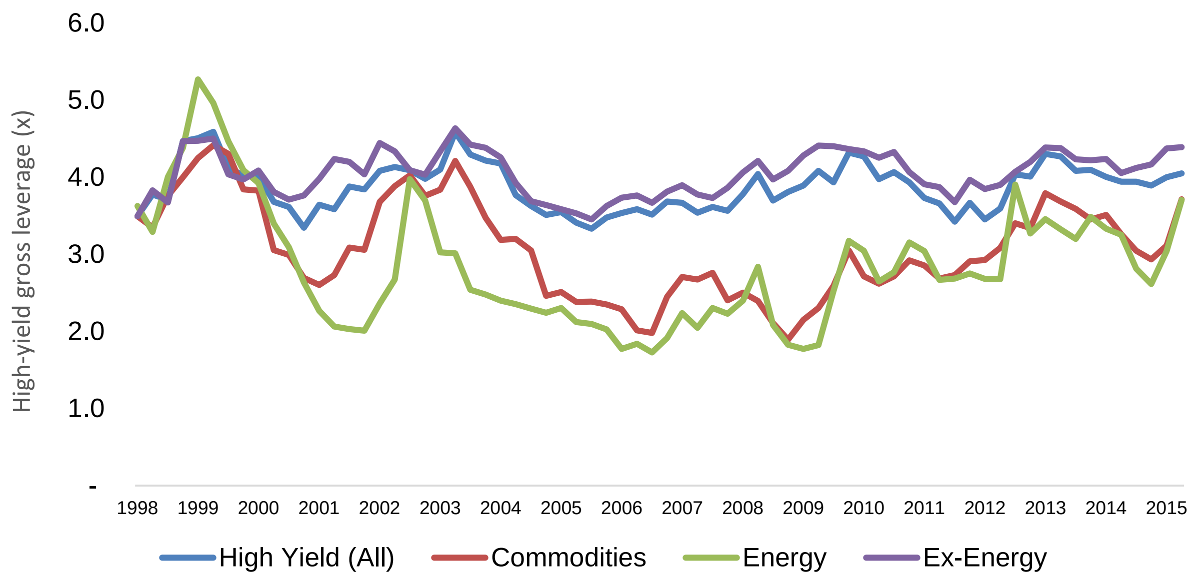
Source: Barclays Capital. Monthly data to July 31, 2000. Daily data from August 15, 2000 to October 20, 2015.

CORPORATE FUNDAMENTALS ARE REASONABLY HEALTHY

Outside the Energy sector, which represents approximately 15% of the U.S. high-yield bond market, credit conditions remain relatively healthy. Corporate leverage has remained flat quarter over quarter (Figure 5). Interest coverage ratios are impressive and corporate maturities have been successfully termed out. Absent a recession, default rates remain quite low (Figure 6). In fact, should the Energy sector experience a 20%

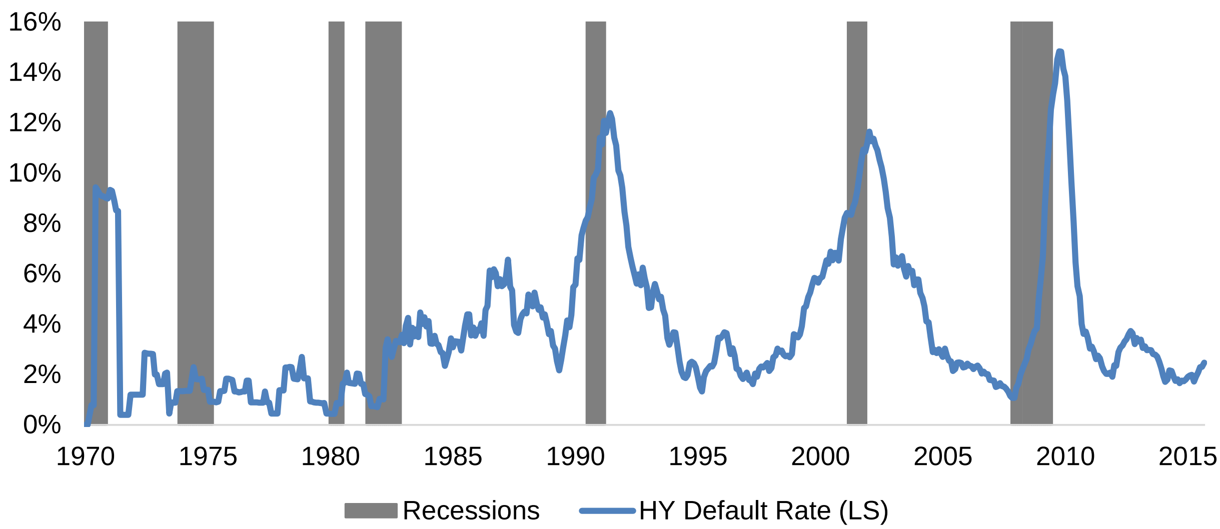
default rate (in an extreme stress case scenario), that would only result in an overall increase of 3% to the broader market's default rate.

Figure 5: High-yield gross leverage



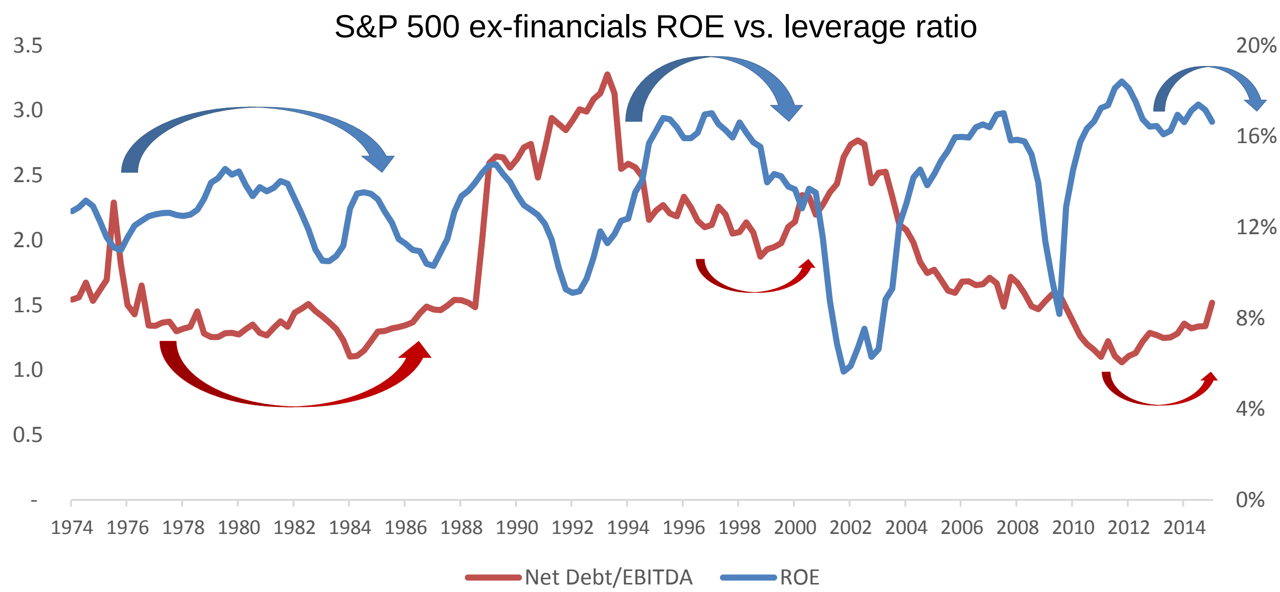
Sources: Bloomberg. Quarterly data from March 31, 1998 to June 30, 2015.

Figure 6: Speculative-grade default cycles



Sources: Moody's, the National Bureau of Economic Research. Monthly data from January 31, 1970 to September 30, 2015.

Figure 7: Corporate re-leveraging – typical late-cycle behaviour



Sources: Bloomberg, AGF Investments Inc.

Historically, when return on equity for the corporate sector peaks, it has been followed by a re-leveraging of balance sheets (Figure 7). This can occur in the form of debt-funded stock buybacks or special dividends where cash is simply returned to shareholders. Conversely, consolidation activities such as mergers and acquisitions or leveraged buyouts can also take place. Operating margins are at record levels, cost-cutting has been largely completed and tax rates are relatively low. In the absence of additional levers to grow EBITDA, management teams tend to increase financial leverage as it is the easiest path to boost return on equity. This financial engineering results in a deterioration of the quality of these balance sheets as it becomes more challenging for a company to grow into its credit metrics and eventually de-lever later in the cycle. It is relevant to note, however, that these activities are typically experienced in the later stages of a credit cycle. We believe that the path to extreme re-leveraging will be a very gradual one as corporations have only just started to lever up. As part of AGF's due diligence process, we constantly seek management teams that possess the willingness and ability to successfully manage their balance sheet through the cycle.

CONVERTIBLE BONDS – SHIFTING FOCUS FROM YIELD TO TOTAL RETURN

Credit investors in the current low-yield environment must rely on total returns instead of outright yield to attain their target level of returns. As an investment-grade and high-yield investor, we aim for an attractive yield for a given level of credit risk alongside modest spread compression. Spread tightening makes up the capital gains component of these securities. The addition of convertible bonds to a portfolio can enhance the capital gain component because of the sensitivity of these bonds to their underlying stocks. The level of capital gains offered by straight bonds pales in comparison to the upside potential that convertible bonds can offer while still maintaining a level of downside protection.

IN CONCLUSION

As we navigate the later stages of the current credit cycle, we are mindful of the challenges and opportunities that lie ahead. From a top-down perspective, we believe that there will be a benign interest rate environment for the coming years, which bodes well for relative credit outperformance. Further, we are constantly identifying investable themes that have the potential to generate superior total returns through the cycle. Bottom-up credit research assists us not only in identifying companies that would expose us to such themes but can also compensate us for taking the given level of credit risk.

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