# PH&N Core Plus Bond Fund

## Fund Performance

| Performance Comparison as of September 30, 2022 (%) | | | | | | | |
|---|---|---|---|---|---|---|---|
| | 3 Mo | 1 Yr | 2 Yr | 3 Yr | 4 Yr | 5 Yr | SI * |
| **PH&N Core Plus Bond Fund** | **0.63** | **-10.47** | **-6.14** | **-0.90** | **1.66** | **1.71** | **3.09** |
| *FTSE Canada Universe Bond Index* | *0.52* | *-10.48* | *-6.98* | *-2.51* | *0.41* | *0.66* | *1.94* |
| Relative Performance | +0.11 | +0.01 | +0.84 | +1.61 | +1.25 | +1.05 | +1.15 |

Series O returns. Total returns are gross-of-fee and reported in Canadian dollars. Periods less than one year are not annualized.

* Inception date: June 30, 2013.

## Fund Attribution

| Attribution as of September 30, 2022 (%) | | |
|---|---|---|
| | Relative Performance | |
| | 3 Mo | 1 Yr |
| Interest rate anticipation | | |
| Duration & yield curve | 0.08 | 0.23 |
| Real return bonds | 0.00 | 0.04 |
| Foreign sovereign bonds | 0.08 | 0.08 |
| Credit & liquidity | | |
| Provincial & quasi-government bonds | 0.02 | 0.11 |
| Investment grade corporate bonds | 0.00 | 0.07 |
| High yield corporate bonds | 0.02 | -0.18 |
| Mortgages | 0.00 | 0.00 |
| Emerging market debt | -0.07 | -0.34 |
| Other | -0.02 | 0.00 |
| **Total** | **+0.11** | **+0.01** |

## Third Quarter Review

| Strategy Summary for the Quarter Ending September 30, 2022 (relative contribution to duration exposure) | | | |
|---|---|---|---|
| **Strategy** | **Change Over Q3** | **Position Ending Q3** | **Our View** |
| Duration & Yield Curve | Unchanged | Neutral duration | Uncertain economic outlook and volatile rate environment prompting modest duration positioning |
| Real Return Bonds | Unchanged | No position | Long-term market-implied inflation expectations in line with our view of fair value |
| Foreign Sovereign Bonds | Adjusted | Small position | Yield differential between U.S. treasuries and Government of Canada bonds at attractive level |
| Provincial and Quasi-Government Bonds | Increased | Moderate overweight in provincials; underweight in federal agencies | Valuations more attractive for provincial bonds relative to federal agencies |
| Investment Grade Corporate | Unchanged | Modest overweight | Focused on high-quality credits against backdrop of rising recession risk |
| High Yield | Increased | Modest position | Valuations compelling, but we are mindful of the growing list of risks in the current environment |
| Mortgages | Unchanged | Small position | Liquidity premium remains at appealing levels |
| Emerging Market Debt | Unchanged | Small position | Cognisant of credit risk; however, reward-for-risk profile remains appealing |

- While it appears that peak inflation may be behind us, it is likely to remain well above the target range for some time to come, and over the quarter central banks remained steadfast in their commitment to raising policy rates to curb demand. The Bank of Canada (BoC) executed two oversized rate hikes, bringing the policy rate up 175 basis points (bps) into restrictive territory. Yields fell at the start of the quarter as recession fears percolated but climbed back after central banks reaffirmed their hawkishness, only to fall again in the last week of the quarter in response to a policy clash overseas. Against this backdrop, bond market returns were modestly positive, with the FTSE Canada Universe Bond Index returning 0.52%.
- On a year-to-date basis, bond market performance is still meaningfully negative, as a result of the sharp rise in yields experienced through the first half of 2022. However, recall that this means the yield for your portfolio is significantly higher than at the beginning of the year, which improves prospective returns going forward.
- In aggregate, the portfolio's duration and yield curve positioning was a positive contributor to relative performance because it benefitted from a flattening of the yield curve.
- A small position in U.S. Treasuries was a positive contributor to performance as we tactically capitalized on the large yield differential between U.S. Treasuries and similar-term government of Canada bonds during the quarter.
- Exposure to provincial and government agency bonds added value due to security selection.

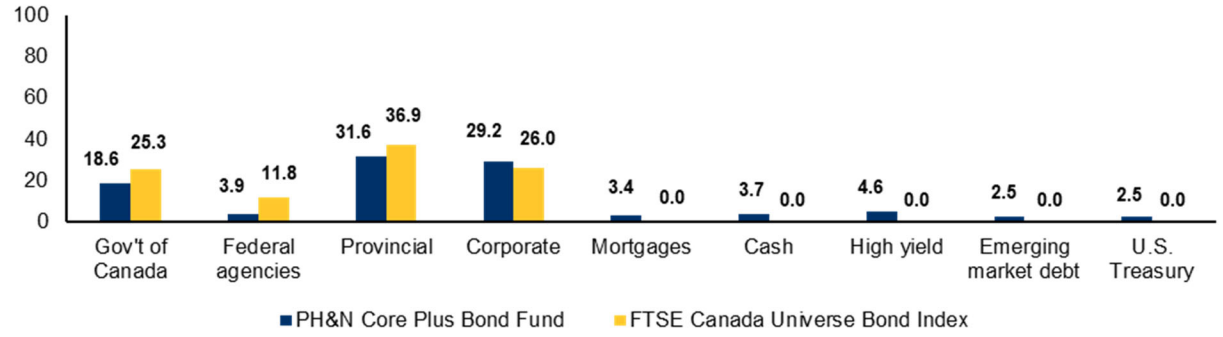
- The portfolio’s overweight to investment grade corporates was a neutral contributor to relative performance.
- The out-of-benchmark positions in high yield bonds and mortgages had no material impact on relative returns, whereas emerging market debt detracted from relative performance due to spread widening over the quarter.

# PH&N Core Plus Bond Fund Portfolio Structure as of September 30, 2022

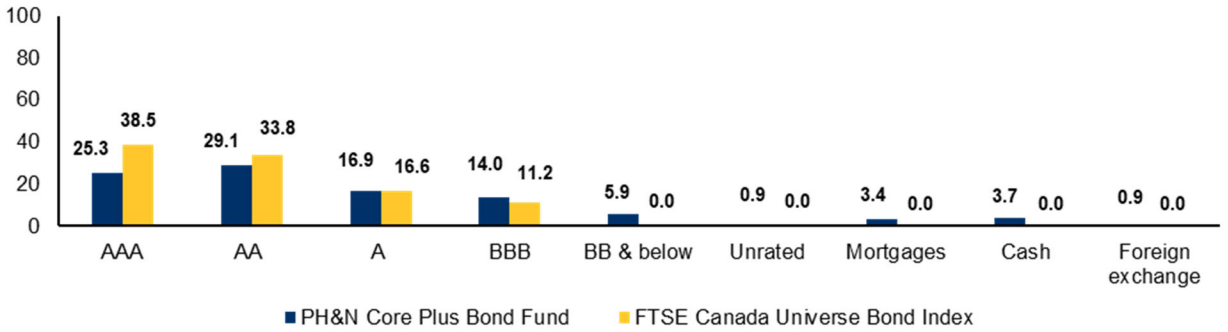
**Fund Characteristics**

| | Modified Duration (Yrs)* | Term to Maturity (Yrs) | Yield to Maturity (%) |
|---|---|---|---|
| PH&N Core Plus Bond Fund | 7.43 | 10.93 | 4.63 |
| *FTSE Canada Universe Bond Index* | *7.48* | *10.35* | *4.15* |

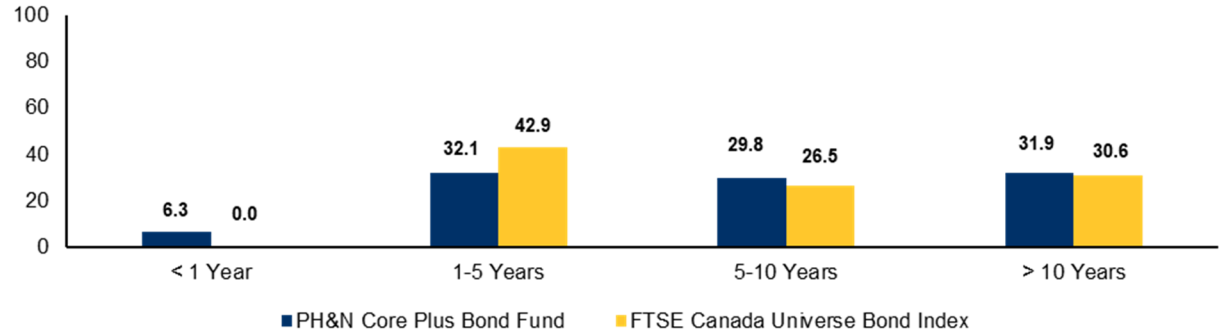
## Issuer Analysis (%)




## Rating Analysis** (%)




## Maturity Analysis (%)




* Duration includes the duration of foreign instruments. Due to the Fund's foreign bonds having a much lower correlation to Canadian interest rates than implied by a conventional duration calculation, the reported duration measure does not correctly estimate true economic sensitivity of the Fund to Canadian base rates.

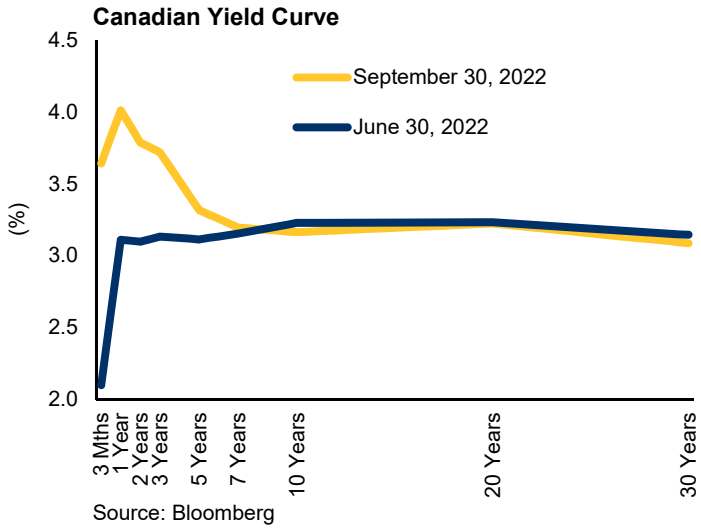
** Current ratings based on average across rating agencies (DBRS, Moody's, S&P) where available. Ratings at the time of purchase may differ.

Totals may not add to 100% due to rounding.

# Third Quarter Review

## Duration and Yield Curve

After inflation reached a 40-year high, the BoC surprised markets with an outsized policy rate hike of 1.0% in July – the biggest in nearly 25 years and largest increase by any G7 central bank during the current tightening cycle. This was followed by another outsized increase of 0.75% in early September, leaving the policy rate in restrictive territory, at 3.25% to end the quarter. This hawkishness prompted yields, which were trending lower throughout July on fears of impending recession, to switch course and move higher. The final days of the quarter then brought significant volatility to global bond markets as a result of a meaningful divergence in Britain's monetary and fiscal policies, which led to massive swings in U.K. bond yields. Against this backdrop, short-term GoC yields rose significantly over the period, while long-term yields ended slightly lower, resulting in a meaningful flattening and inversion of the GoC yield curve.




Throughout the quarter, the portfolio's sensitivity to interest rates was managed fairly closely to that of the benchmark, with the portfolio duration ending the period roughly in line with the benchmark. This neutral positioning reflects our low conviction on the near-term direction of interest rates due to a wide range of potential outcomes. If high inflation persists, yields could continue to rise. That said, peaking inflation would indicate that the current tightening cycle is in the latter stages, suggesting that yields won't rise further from here. The portfolio's yield curve positioning is partly a function of the team's expectations for the evolution of yields but also a function of where we see the most attractive opportunities within credit and liquidity strategies, and we currently have a preference for mid- to longer-term credit. Overall, the portfolio's duration positioning had a neutral impact on relative performance over the quarter, but the yield curve positioning contributed significantly to relative performance.

**Government of Canada Yields (%)**

| | 1 Yr | 2 Yr | 5 Yr | 10 Yr | 30 Yr |
|---|---|---|---|---|---|
| September 30, 2022 | 3.99 | 3.77 | 3.32 | 3.18 | 3.11 |
| Forward Curve for September 30, 2023 | 3.54 | 3.41 | 3.08 | 3.10 | 3.06 |
| **Implied Change (1 year)** | **-0.45** | **-0.36** | **-0.24** | **-0.08** | **-0.05** |

Source: Bloomberg, RBC GAM (BondLab)

Looking forward, while further rate hikes before the end of the year are more or less written in stone, this expected change has already been priced into the bond market. In fact, looking out further over the coming year, the market expects short-term yields to fall meaningfully, with long-term yields expected to remain relatively unchanged from current levels. The trajectory of the forward curve implies that the BoC will actually cut interest rates in the latter half of 2023 in the face of an impending economic slowdown. We foresee a broad range of outcomes for the direction of bond yields in light of competing views on how inflation will unfold, but generally our view is in line with what is priced into the bond market. However, we do believe that yields will continue to exhibit heightened volatility in the near term as a result of central bank actions, investor confidence in their ability to rein in inflation, and the lag between tightening and its impact on inflation. Periods of such market volatility provide opportunities for value added and we will continue to look for opportunities to be tactical in our duration positioning to capitalize on such an environment.

## Real Return Bonds

The annual inflation rate, as measured by headline Consumer Price Index (CPI), decelerated from 8.1% in June to 7.0% in August, which marked the second consecutive monthly decline in year-over-year price growth. While inflation is seemingly peaking, the components of high inflation continued to broaden in scope and the market consensus is for above-average inflation to persist over the short term.

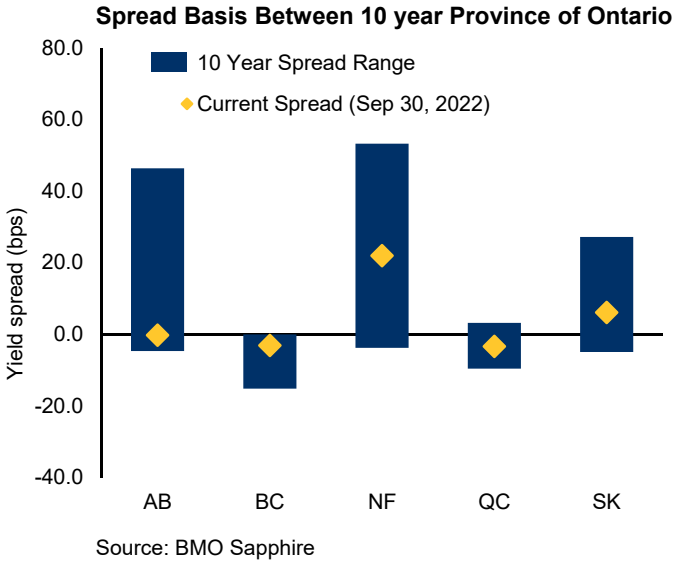
Currently, we have no exposure to real return bonds as the bond market's expectation for long-term inflation (estimated as the difference in yield between a nominal and a real return bond) is trading at levels in line with our view of fair value. Going forward, we will continue to monitor the strategy as actual and expected inflation conditions evolve.

## Foreign Sovereign Bonds

Last quarter, we initiated a short position in a currency-hedged 10-year U.S. Treasury bond as the difference in yield, or spread, between 10-year Government of Canada (GoC) and U.S. Treasury (UST) bond yields increased to the widest levels seen in almost 10 years. We unwound the trade in July at a gain as the yield differential between 10-year GoCs and USTs compressed to more normalized levels.

Late in the third quarter, the spread differential between GoCs and USTs gapped out again; however, this time in the opposite direction, with 30-year UST yields trading significantly higher than 30-year GoC yields. We think fundamentally there is a case for UST yields to be higher than GoCs; however, the speed and magnitude of the spread movement suggested that it was being driven by short-term technical factors. As such, we initiated a long position in currency-hedged 30-year USTs in mid-September, as we expect the spread differential between the two sovereign yields to reverse course and return to more normalized levels.

## Quasi-Government Bonds



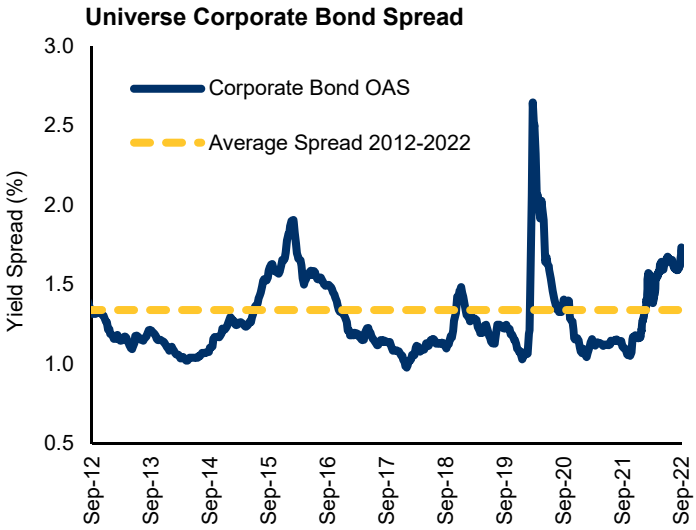

During the quarter, uncertainty continued to dominate market headlines with spreads reacting to varying degrees across all provinces and terms. Commodity-sensitive provinces experienced the greatest spread widening over the quarter as the price of oil regressed. Meanwhile, the other provinces benefited from spread tightening across shorter maturities. Overall, provincial spreads collectively ended the quarter with similar spread levels to where they began. Provincial new issuance was modest in the third quarter with approximately $13 billion coming to market, which represents the completion of approximately 45% of provincial funding needs for the current fiscal year. Looking forward, stronger fiscal trajectories, coupled with reduced borrowing needs, should remain supportive for provincial credit spreads. That said, if a recession materializes, provincial bonds, alongside other risk assets, would experience weakness.

Overall, the portfolio's provincial overweight was increased over the period. This was accomplished in large part through a reduction in our underweight exposure to the province of Quebec, which is now in line with the benchmark. From a fundamental standpoint, we believe that Quebec has demonstrated improved fiscal stability. Furthermore, from a valuation standpoint, we feel that given the improvements that have taken place over an extended period, the current valuation in relation to the province of Ontario is likely fair, whereas in the past Quebec bonds would have been viewed as expensive. Following the recent increase in exposure to the province of Quebec, the portfolio's largest underweight is now the province of British Columbia, where we have concerns over the province's significant exposure to the levered real estate market. The portfolio's largest provincial exposure remains the province of Ontario, which offers superior liquidity and steady fundamentals relative to the other provinces, and provides us greater ability to be tactical.

We continue to find the value of federal agency bonds, such as AAA-rated Canada Housing Trust bonds, to be less attractive versus other higher-yielding credit strategies. As such, the portfolio remains positioned with an underweight exposure to this segment of the quasi-government bond market. In aggregate, the portfolio has a neutral exposure to provincial and quasi-government bonds, and maintains a meaningful bias toward provincial bonds given their yield advantage over government agency bonds.

The portfolio's exposure to provincial bonds contributed positively to relative performance as a result of security selection decisions over the quarter. We will continue to tactically adjust the portfolio's quasi-government positioning based on the attractiveness of opportunities relative to other segments of the bond market.

## Investment Grade Corporate Bonds



Source: FTSE Global Debt Capital Markets Inc.

While interest rate volatility continued to dominate corporate bond market narratives again this quarter, appetite for risk remained healthy with credit spreads compressing for much of the quarter. However, in the face of increasingly hawkish central bank rhetoric mid-quarter that dashed hopes for a soft landing and dented investor confidence, spreads moved wider, unwinding the tightening seen earlier. Unsurprisingly, with many companies having pre-funded in the previously low-rate environment, corporate issuance underwhelmed again this quarter with approximately $20 billion of new supply coming to market, down 26% from the third quarter in 2021. The muted primary market activity over the typically slow summer months helped support broad Canadian corporate bond spread levels. However, the risk-off tone that hit markets late in the quarter resulted in spreads ending the period slightly wider than where they began.

From a fundamental standpoint, high debt levels among consumers and corporations remain the key vulnerabilities to the Canadian economy that we are concerned about in the current environment. Canadian consumer indebtedness remains elevated, and the cost to service that debt has increased significantly alongside higher interest rates. On the corporate side, sustained high inflation poses a potential headwind, as it may begin to put pressure on corporate earnings.

We remained very selective in the primary market this quarter, opportunistically participating in some attractively priced new issues from issuers with stable fundamentals. We are cognisant of the uncertain market backdrop and that we appear to be in the late-stage of the credit cycle, so along with maintaining a modest overweight exposure relative to the benchmark, we continue to favour the higher-quality, less-cyclical sectors of the corporate bond market like infrastructure and power generation, which include regulated issuers that have stable and predictable cash flows. Overall, the portfolio's overweight exposure to corporate bonds did not have a meaningful impact on relative performance.

## Private Placement Corporate Bonds

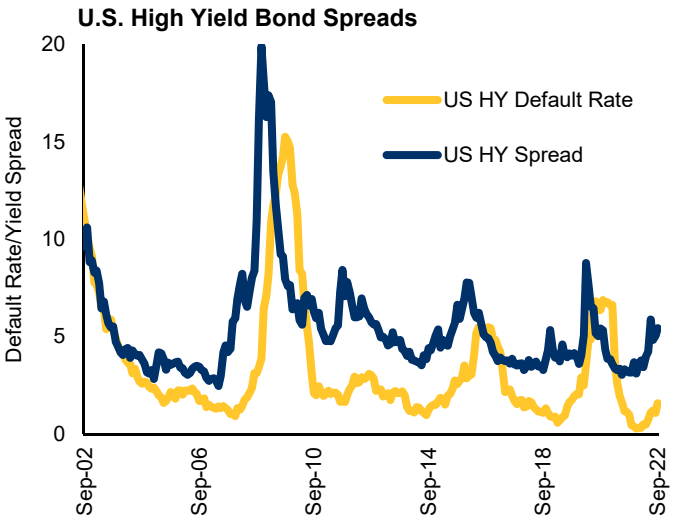
The portfolio's allocation to private placement corporate bonds is achieved through an allocation to the PH&N Private Placement Corporate Debt Fund (PPCDF). The PPCDF invests in investment grade private placement corporate bonds issued primarily in Canada but also abroad. For bonds unrated by an agency, PH&N will assign an internal rating, which must be of investment grade quality to qualify. One of the benefits of investing in private debt is the opportunity to expand and diversify investment opportunities. While many of the issues are infrastructure related, the private debt market encompasses many industries and sub-industries not available in the "public" markets. In addition, private placements often provide attractive illiquidity premiums for investors because they do not tend to have an active secondary market.

Private placement corporate bond spreads widened by around 3 bps over the quarter, which was lower than what was witnessed in comparable-term public securities within the broader Canadian corporate bond market. Coupled with lower GoC bond yields over the quarter, the fund returned 0.8%. The extra spread over public corporate bonds provides an ongoing return tailwind.

The PPCDF did not participate in any new deals over the quarter. With respect to the current pipeline of new opportunities, we are currently engaged with a number of issuers on potential deals related to renewable power and public private partnerships (P3s). We access investment opportunities for the PPCDF via the private placement desks of bond dealers that are our traditional counterparties in public corporate bond markets. Our expectations for yield enhancement within this sector are in the order of 75–100 bps over public market opportunities of similar credit quality.

## High Yield Corporate Bonds

High yield bonds posted positive returns in the third quarter, reversing steep declines in the first half of 2022, which saw some of the worst year-to-date returns in 35 years. This rebound was driven by tighter credit spreads despite rising yields (particularly in the short-end of the curve). The U.S. Federal Reserve hiked its benchmark interest rate by 150 bps in the third quarter, announcing 75 bps hikes in both July and September. These jumbo hikes continue to rattle fixed income markets, and the risk of a central bank-induced recession has become very likely. While the shorter duration nature of high yield bonds previously helped soften the impact of rising rates, investors are increasingly flocking to the safety of USTs and investment grade corporates fearing an upcoming recession.




Source: Bloomberg. US High Yield spread represented by ICE BofA Merrill Lynch US High Yield index. US high yield default rate represented by ICE BofA Merrill Lynch US High Yield index to Dec 31 2019, JPMorgan Jan 31 2020 to current.

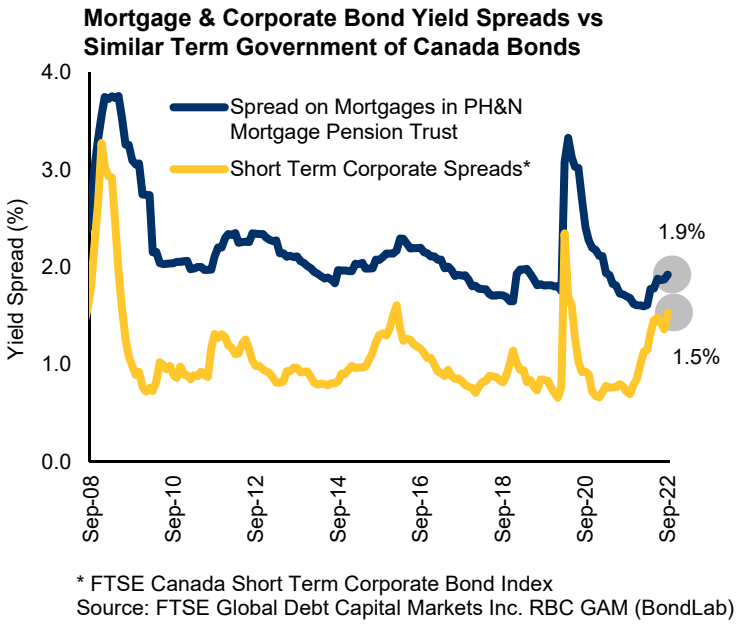
High yield issuance slowed dramatically in the third quarter as rising yields and recessionary fears drove investors to safety and held back issuers from issuing bonds into this softening demand. This risk-averse sentiment was exacerbated by a slowing economy, lingering effects from the pandemic, and an energy crisis triggered by the conflict in Ukraine. While default rates remain near historical lows, the high yield distress ratio is rising and default volumes continue to trend upwards, causing investors to act with a heightened level of caution.

Corporate profits may soon encounter headwinds, as slowing economic growth is likely to weigh on earnings. While earnings estimates remain solid in 2022, some analysts are starting to reflect softness into 2023, and further downward revisions are possible given earnings are well above their long-term trend. Valuations for high yield bonds have recovered somewhat, with OAS spreads on the ICE BOA U.S. HY index falling from 587 bps in June to 543 bps on September 30. Oil prices remained elevated for most of the quarter due to constrained supply but started to retreat in the face of weakening global demand and a strong U.S. dollar. While inflation remains stubbornly high, most indicators have begun to flatten out or decline, suggesting inflation may have finally peaked.

The portfolio's high yield position was increased over the quarter. Despite looming risks, we feel the reward for risk in carefully selected high yield bonds is compelling, with index yields near 9%. And with opportunities to find 6–7% yields in undervalued investment grade instruments within our high yield portfolios, we feel like there is no need to take on outsized credit risk. We therefore continued to favour a defensive position from an overall credit quality standpoint.

## Mortgages

As of quarter-end, the mortgages held in the portfolio had a yield of approximately 192 bps over similar-term GoC bonds, representing a 4-bps increase from the previous quarter. Spread widening reflected broader market uncertainty and the impact of forceful actions taken by central banks to curb heightened inflation.




Of the four core sectors, office continues to be the one facing the most uncertainty in the current market environment; however, the well-located assets with strong sponsorship and attractive leasing profiles that we look for have continued to perform well in the current market conditions. Extremely low supply levels within major industrial markets have led to the lowest national vacancy rate on record and caused rental rate growth across the country as companies have revamped supply chains to make use of available industrial space within traditionally smaller industrial markets[1]. Conditions for the retail sector continued to improve during the third quarter with Google mobility statistics indicating an increase in foot traffic at grocery- and drug-anchored retail, which contributed to declining vacancy and rising rental rates nationally, creating an environment for stable and growing cash flows for retail borrowers to support mortgage debt payments[2]. While this momentum is encouraging, the macroeconomic backdrop of a slowing economy experiencing declining consumer purchasing power poses risks to the sector's solid recovery. In multi-residential, interest rates have increased the costs of home ownership, pushing some would-be homeowners into the rental market and driving up rental rates across the country. Alongside this, strong immigration flows, a considerable supply-demand imbalance, and back-to-school have all underpinned strength in rental market conditions.

During the third quarter, we funded an additional $152 million of new loans. While our lending posture has been focused on industrial and multi-residential, 69% of the new origination this quarter is backed by office and retail properties. We have been broadly cautious in loaning against these sectors through the pandemic, but the loans we funded were very attractive for a number of reasons. All loans came with attractive coupons, recourse, high-quality borrowers/sponsors, conservative leverage metrics, and strong cash flow coverage to support mortgage payments through the term of the loans. The balance of new mortgages was backed by industrial properties (24%) and multi-residential (7%).

[1] CoStar "Industrial Tenants Ask Themselves 'Where's the space'" – September 8, 2022
[2] CoStar "National Retail Report"

## Emerging Market Debt (EMD)

We believe that EMD presents a unique opportunity to diversify sources of value-added within the portfolio, given its attractive yield profile, solid credit quality, and lower correlation to Canadian fixed income instruments. Alongside other risk assets, EMD suffered a volatile third quarter, which was driven by recession fears, rising UST yields, and continued concern surrounding high inflation. As a result, the portfolio's EMD allocation detracted from performance. Hard and local currency sovereign bonds, and hard currency corporates posted meaningful negative returns over the quarter. Poor performance from the aforementioned sectors was somewhat offset by emerging market foreign exchange (EMFX) which posted positive returns as they performed well against the Canadian dollar.

Alongside the macro headwinds that are plaguing all risk assets, EMD also grappled with technical factors. The U.K. experienced a series of policy missteps, resulting in a rapid sell off in U.K. gilts toward the end of the quarter. This forced many pension investors to sell liquid assets to meet margin calls, including EMD assets, which put additional downward pressure on an already struggling sector. Additionally, risk sentiment was further dampened when Russia mobilized more troops, marking another escalation in the conflict with Ukraine. That said, Ukraine has reportedly achieved significant victories against Russia during this war, which could strengthen its negotiating power.

Over the quarter, hard and local currency sovereign bonds were the worst-performing EMD sleeves. Hard currency sovereign bonds struggled as the sector's longer-duration bias made it more susceptible to rising U.S. treasury yields. Negative return within local currency sovereign bonds was entirely driven by the FX component, which depreciated against a remarkably strong USD. Within hard currency corporates, credit spreads remained surprisingly resilient; however, spreads still widened as global risk sentiment waned. Finally, EMFX posted positive returns, as EM central banks are relatively far along their rate hiking trajectories, leading EMFX to outperform the Canadian dollar.

Looking ahead, the outlook for EMD is mixed. Significant repricing has occurred within the EMD sector with yields reaching decade highs and valuations at very compelling levels. However, considerable headwinds exist and present challenges for EMD going forward. Most notably, the global energy crisis still remains unresolved. Eastern European countries, which are dependents on Russian gas, remain particularly vulnerable. Another significant risk resides within stressed issuers, as there are a number of EM countries grappling with domestic political turmoil and seemingly unable to make positive policy decisions. Overall, we think diversification remains the key to success in this environment, as does investing in liquid and high conviction assets with a focus on downside protection.