Fixed Income

COMMENTARY Q3 2016
RICK BROWN

FRONT STREET CAPITAL
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FRONT STREET TACTICAL BOND CLASS

MARKET OVERVIEW

The third quarter of 2016 started with markets attempting to digest the impact of the U.K.'s vote to exit the European Union ("Brexit"). Despite uncertainty around the vote's implications, it quickly became clear that the exit will involve prolonged negotiations. Because the U.K. did not immediately trigger Article 50 to begin the exit process—coupled with low yields—expectations for further stimulus and supportive economic data helped alleviate investor concerns. This, in turn, paved the way for a rally in risk assets, with most asset classes performing reasonably well.

Later in the quarter, the focus shifted to the timing of interest rate increases by the Fed and the rate of future interest rate moves. U.S. 10-year yields started the quarter at + 1.47%, and ended at +1.595%, but fluctuated significantly, with a low of +1.359% on July 8 to a high of +1.728% on September 13.

Most fixed income asset classes performed reasonable well during the quarter, but high-yield and investment-grade corporates led the way as credit spreads tightened. Treasuries lagged as investors sold these assets to take on more risk. The improved market sentiment helped to drive performance and money flows, which helped to deliver a decent quarter for the market.

The Canadian economy got a boost from recovering oil prices and a weaker Canadian dollar, which should support exports. Continued price appreciation of the housing market has become a significant concern, and the government has taken steps to slow the market. So far, the move appears to be working as prices in Vancouver have cooled slightly.

FRONT STREET TACTICAL BOND CLASS

FUND MANAGER: RICK BROWN

The Front Street Tactical Bond Class performed reasonably well on the back of tightening credit spreads, which led to higher bond prices for most holdings. The Fund performed particularly well in August and during the first half of September, but struggled later in the month after we shortened its overall duration following the Fed's meeting. As a result, the Fund did not receive the benefit of interest rates moving 10 basis points lower over that period.

Exposure to U.S. chemical companies and pipelines boosted the Fund's performance. Our short duration bias contributed to overall performance, but dragged on performance in late September. Given the rally of risk assets, the riskiest of those performed particularly well. Unfortunately, we missed some of the upside potential by limiting our risk. In this type of rally, the Fund's riskier peers should outperform, but our priority is to focus on capital preservation.

We believe that interest rates will continue to trend slightly higher, and credit spreads should continue to rally as investor appetite for yield drives money into high-yield assets. The market anticipates that the Fed will raise interest rates at its December meeting. We continue to favour higher-quality high-yield investments with a shorter duration profile. We feel confident that the Fund will achieve, and perhaps exceed, the total return target we set at the beginning of the year (a 4% to 5% return).

FRONT STREET CAPITAL

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