

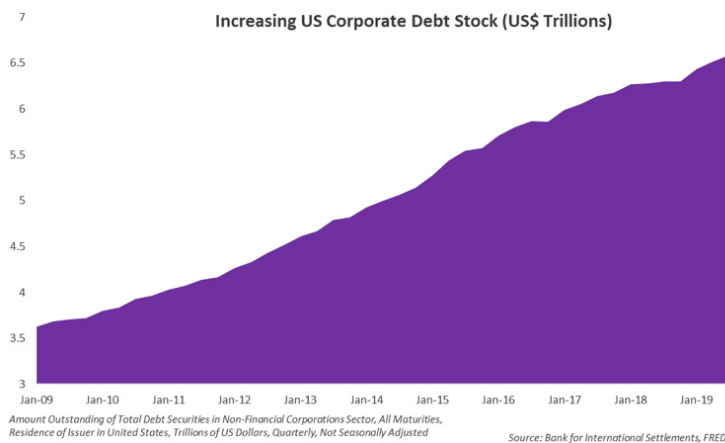
Coronavirus Pandemic Credit Market Dislocation: The Upcoming Stressed & Distressed Cycle Opportunity

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Credit: The Current Environment & Opportunity Set

The coronavirus pandemic that began in late 2019 and proliferated in Q1 2020 has had a profound impact on the global economy and financial markets, which could lead to a generational opportunity in stressed and distressed credit. Corporate borrowing over the last decade has ballooned and many companies, some of which are high quality borrowers, are now finding themselves in a precarious situation due to the chain of events set off by the pandemic and the ensuing economic shutdowns. In the US, the corporate bond market grew by ~ 80% from 2009 to 2019 (the US high yield market reached US\$1.5 trillion and all non-financial corporate debt reached US\$6.6 trillion). Meanwhile international markets grew even faster.ⁱ



In spite of the global economy stagnating, these companies still have to meet their financial obligations and will be looking to refinance. However, for some companies the only option may be to file for bankruptcy to either restructure or liquidate. Due to this environment there is likely to be a large wave of stressed and distressed credit situations that will present compelling investment opportunities in the months and years to come.

“Under such circumstances (i.e. crises), no one wants to provide capital, the credit market freezes up, and proposed offerings go begging. This puts the cards into hands of providers of capital rather than the borrowers...”

- Howard Marks

We believe that the opportunity set is two-fold:

1. We expect that dispersion across credit markets will increase dramatically going forward. This creates a rich opportunity for active managers with strong fundamental credit analysis capabilities who can differentiate the ‘winners’ from the ‘losers’. The so-called ‘winners’ will likely be the bonds issued by companies that are less economically sensitive and have better balance sheets. These bonds should be the ones to recover in value after the recent widening in credit spreads. Meanwhile, companies that are in the ‘eye of the storm’ – such as travel, leisure, and retail – could be the so-called ‘losers’ that will see the value of their credits continue to face strain. Long/short credit managers can profit from this aforementioned dispersion – buying discounted bonds on the higher quality end of the spectrum that they expect to recover, while going short bonds that may not be accurately reflecting the magnitude of risk involved for certain lower quality borrowers.
2. Additionally, we expect there to be a multi-year distressed cycle and investment opportunity. The financial strain on certain companies may lead to liquidity and insolvency issues, causing them to default. In fact, there is already evidence that this trend has begun with the recent bankruptcy filings by the likes of JCPenney, Neiman Marcus, J. Crew, Diamond Offshore Drilling, Whiting Petroleum, Hertz, and Intelsat to name a few. It is a common misconception that a default or bankruptcy implies ‘no value’; however, for distressed credit investors there can be opportunity for significant returns. While a bankruptcy might destroy the value of the equity and other subordinated portions of the capital structure, it can create meaningful value for creditors in the senior portions of the capital stack. Distressed credit investors will purchase bonds and loans at a significant discount to par with the goal of taking control of the assets in the bankruptcy process in order to achieve a recovery value well in excess of their cost basis.

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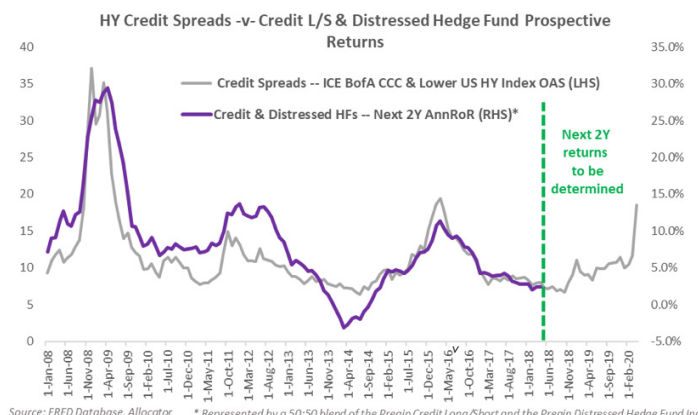
What About the Recent Rally Off the Market bottom?

A devil's advocate might ask whether the opportunity has come and gone as markets have rallied significantly off the March lows. This might be the case for passive mutual fund and ETF investors, but not for active managers that can go long and short to benefit from dispersion amongst various credits and those that can get involved in distressed situations. While some of the long side opportunity has dried up in the investment grade space, certain companies might be short candidates and we have seen an uptick in downgrades (there have been 24 *'fallen angels' so far in 2020).ⁱⁱ According to S&P, "as credit pressure continues to build, the number of potential future 'fallen angels' has reached 111 and nearly one-quarter [of them have] ratings on CreditWatch with negative implications – both are record highs."ⁱⁱⁱ Meanwhile, high yield markets remain rich with opportunity as they continue to face stress as indicated by persistently high credit spreads (i.e. the ICE BofA CCC & Lower US High Yield Index Option-Adjusted Spread as of May 27th, 2020 remains elevated at ~17% versus an average spread of ~10% since 2010 and only slightly off its recent March peak of ~19%).^{iv}

**"When written in Chinese, the word 'crisis' is composed of two characters - one represents danger, and the other represents opportunity."
- John F. Kennedy**

How Is Cidel Capturing This Opportunity?

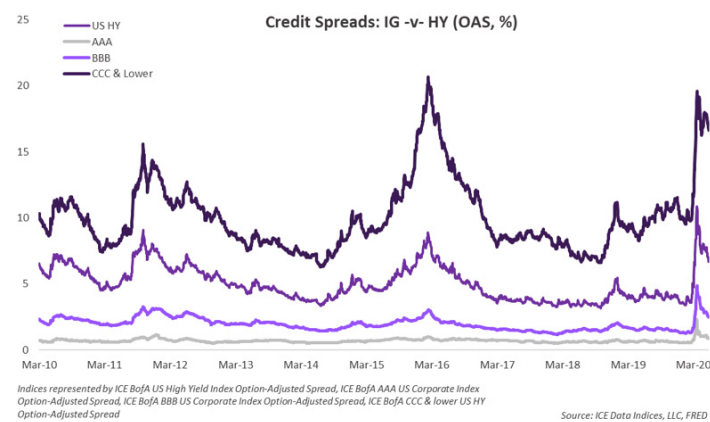
Cidel has seen this movie before. Cidel, as a firm, is a seasoned and long-term allocator in the credit space having been invested in these types of strategies since 2007. We have seen the benefits of including alternative credit in portfolios over time and especially in the aftermath of prior market cycle downturns such as the Global Financial Crisis in 2008, the European Debt Crisis in 2011, and the prior Energy Crisis in 2015-16. History shows that in the wake of a credit cycle downturn, alternative credit strategies (such as distressed and long/short credit), have offered strong prospective returns given the aforementioned opportunities that tend to arise in these periods.



Source: FRED Database, Allocator * Represented by a 50:50 blend of the Preain Credit Long/Short and the Preain Distressed Hedge Fund Index

Chart Commentary: The 'grey' line shows the historical level of credit spreads, which tend to increase during times of market stress. Meanwhile, the 'purple' line shows the 2-year prospective (forward-looking) returns of alternative credit and distressed hedge fund strategies. The pattern shows that when credit spreads increase, so do the return prospects for alternative credit strategies.

To conclude, market crises breed opportunity and we have identified opportunity within credit markets today. Cidel has been proactive in developing solutions to enable our clients to benefit from what we believe will be attractive returns in the coming years as credit markets work through the challenges brought on by the Coronavirus pandemic. These solutions include: i) **The Cidel Alternative Strategies Relative Value Fund**, which is a multi-strategy product that contains material



Indices represented by ICE BofA US High Yield Index Option-Adjusted Spread, ICE BofA AAA US Corporate Index Option-Adjusted Spread, ICE BofA BBB US Corporate Index Option-Adjusted Spread, ICE BofA CCC & lower US HY Option-Adjusted Spread

Source: ICE Data Indices, LLC, FRED

Chart Commentary: This chart is showing that the lower down you go on the credit quality spectrum, the higher the spreads are in both absolute terms and relative to their pre-crisis levels. This implies that while certain credit indices appear to have significantly recovered from the March lows, there remains segments of the markets still showing signs of stress.

*Fallen angel refers to a debt issuer that has been downgraded by credit ratings agencies below an investment grade level; i.e. to high yield or junk bond status.

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exposure to credit strategies; and ii) a new tactical offering called **The Cidel Credit Opportunities Fund**, which is purely dedicated to capturing this opportunity (Note: Target launch date is July 1st, 2020).

If these products are of interest to you, we encourage you to reach out to your Cidel representative with any inquiries.

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- iv) FRED; ICE Data Indices, LLC
- v) FRED; ICE Data Indices, LLC; Allocator.com; Preqin