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Quarterly Outlook – Fixed Income
CAUTION REMAINS DESPITE CREDIT MARKET REBOUND

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KEY INSIGHTS

- The monetary policy easing measures of major central banks and signs of improvement on the economic front helped credit and equity markets rebound sharply off their March lows.
- The credit market as a whole may struggle to deliver gains at the pace of the last three months given how strong the rally has been.
- The increasing levels of correlation between markets is concerning and warrants caution.

The second quarter was dominated by a liquidity-inspired rally across risk markets. The monetary policy easing measures of major central banks were supportive for liquidity and the broad functioning of markets. This, together with signs of improvement on the economic front helped credit and equity markets rebound sharply off their March lows to deliver strong gains.

LOOKING FOR FURTHER OPPORTUNITIES IN CREDIT

Going forward, looking for further opportunities in credit is likely to remain important for us as the global economy continues its recovery from a deep downturn. While we see a positive outlook for select names, the market as a whole may struggle to deliver gains at the pace of the last three months given how strong the rally has been, alongside expectations that defaults are likely to pick up over the next few months.

This backdrop explains why we continued to add to select corporate bonds and credit issuers during the period, while also taking profits on some names and maintaining a certain level of defensive credit hedges in place.

Overall, we are taking a wait-and-see approach given the current market backdrop. While signs of a rebound in economic activity are encouraging, we are mindful of risks that could trigger future bouts of market volatility. This includes, the renewal of the U.S.-China tensions, the upcoming U.S. election, and the possibility of second coronavirus waves and further economic shutdowns.

CONCERNS ABOUT HIGH LEVELS OF CORRELATION BETWEEN MARKETS

The increasing levels of correlation between markets is also concerning and warrants caution. For example, the U.S. dollar, government bond curves, commodity prices, and credit and equity markets all appear to be driven by the same set of common factors, most notable of which is the expectation for growth to continue improving. This leaves them vulnerable should growth disappoint.

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Against this backdrop, we feel that it’s important to keep defensive hedging positions in place to keep risk in the portfolio balanced. We also maintain a high level of duration with long positioning in a range of high-quality markets. This should help give us flexibility to adapt quickly to changes in market conditions and take advantage of any pricing anomalies and dislocations that might occur.

RISKS

The following risks are materially relevant to the portfolio.
ABS/MBS risk – These securities may be subject to greater liquidity, credit, default and interest ra te risk compared to other bonds. They are often exposed to extension and prepayment risk
Contingent convertible bond risk – contingent convertible bonds have similar characteristics to convertible bonds with the main exception that their conversion is subject to predetermined
conditions referred to as trigger events usually set to capital ratio and which vary from one issue to the other.
China Interbank Bond Market risk – market volatility and potential lack of liquidity due to low trading volume of certain debt securities in the China Interbank Bond Market may result in prices of certain debt securities traded on such market fluctuating significantly.
Country risk (China)- All investments in China are subject to risks similar to those for other emerging markets investments. In addition, investments that are purchased or held in connection with a QFII licenceor the Stock Connect programmay be subject to additional risks.
Country risk (Russia and Ukraine)- In these countries, risks associated with custody, counterparties and market volatility are higher than in developed countries.
Credit risk- A bond or money market security could lose value if the issuer's financial health deteriorates.
Currency risk- Changes in currency exchange rates could reduce investment gains or increase investment losses.
Default risk- The issuers of certain bonds could become unable to make payments on their bonds.
Derivatives risk- Derivatives may result in losses that are significantly greater than the cost of the derivative.
Emerging markets risk- Emerging markets are less established than developed markets and therefore involve higher risks.
High yield bond risk – a bond or debt security rated below BBB- by Standard & Poor's or an equivalent rating, also termed 'below investment grade', is generally subject to higher yields but to greater risks too.
Interest rate risk- When interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality.
Issuer concentration risk- To the extent that a portfolio invests a large portion of its assets in securities from a relatively small number of issuers, its performance will be more strongly affected by events affecting those issuers.
Liquidity risk- Any security could become hard to value or to sell at a desired time and price.
Prepayment and extension risk- With mortgage- and asset-backed securities, or any other securities whose market prices typically reflect the assumption that the securities will be paid off before maturity, any unexpected behaviour in interest rates could impact fund performance.
Sector concentration risk- The performance of a portfolio that invests a large portion of its assets in a particular economic sector (or, for bond funds, a particular market segment), will be more strongly affected by events affecting that sector or segment of the fixed income market

General Portfolio Risks

Capital risk- The value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.
Counterparty risk – an entity with which the portfolio transacts may not meet its obligations to the portfolio.
Geographic concentration risk- To the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area. **Hedging risk**- A portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended. **Investment portfolio risk**- Investing in portfolios involves certain risks an investor would not face if investing in markets directly. **Management risk**- The investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably). **Operational risk**- Operational failures could lead to disruptions of portfolio operations or financial losses.

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