Sun Life Core Advantage Credit Private Pool

FUND COMMENTARY | Q4 2021

Opinions and commentary provided by SLC Management.

Market review

In 2021, interest rate changes were the dominant driver of returns in Canadian fixed income as the global economy continued to recover and central bank quantitative easing programs started to wind down. As inflation rose persistently over the year, central banks had to take a step back from their view that fiscal and monetary stimulus would only produce transitory inflation. Five-year rates led the Canadian yield curve higher as they rose 78 basis points in 2021, resulting in the Canadian yield curve steepening at the short end. Two-year rates started 2021 with little volatility before rising toward five-year rates, as expected central bank rate hikes were pulled forward by rising inflation. Interest rate volatility was particularly acute in the latter part of the fourth quarter as bond market sentiment continued to be torn between bond selling (driven by increasing consumer price inflation) and bond buying (supported by the potential growth slowing effects of the new Omicron variant of theCOVID-19 virus). Although interest rate volatility was near the top end of its historic range, equity volatility was low versus historical levels and equity markets continued to rise in 2021. While central bank policy became less important as 2021 progressed, their support remains key to keeping asset prices elevated across all financial markets, including bonds, relative to economic fundamentals.

Canadian credit spreads ended 2021 very close to where they started according to the Bloomberg Barclays All Corporate index, but it was a banner year for credit supply as Canadian corporate issuance set a record of $135 billion. Considering maturities of $91 billion, the net corporate supply of $44 billion was also high relative to previous years1. While Canadian banks continue to make up just over a quarter of total issuance, the past two years have seen rising Canadian dollar issuance by insurance companies and foreign banks. Corporate issuance in the shorter terms (five years and under) returned to more normal share of overall issuance in 2021, after dipping significantly in 2020. We continued to see more issuance in the five to 10-year terms in 2021, relative to previous years, and an increasing preference for lower credit quality which continues to be a dominant theme. Lower quality BBB-rated corporate issues outperformed in the short end this year as investors continued to search for yield even though some BBB-rated sectors like REITs and energy still face significant uncertainty in the future. The demand for lower quality also allowed Rogers to issue the first telecom hybrid bond issue since Bell issued the first one in 199..

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Portfolio review

The fourth quarter of 2021 was a volatile quarter for interest rates, though this was not readily discerned by the small 8 basis points decrease in the Canada 10-year bond during this period. Although the Fund's slightly short duration positioning detracted from active returns in the quarter, this was more than offset by benefits of our curve positioning, particularly being underweight in the one to three-year terms versus overweight in the 20-30-year terms. The pressure on the short-term yields was the result of the market's shift from treating inflation as transitory to seeing inflation as having more permanence and thus the potential for Bank of Canada rate hikes being brought forward.

On the credit side, the primary driver of active returns was the Fund's holding in the SLC Management Short Private Fixed Income Plus Fund which handily outpaced there turn of short public corporate bonds by 73 basis points in the quarter. This holding contributed just over 7 basis points of active return to the Fund.

Portfolio positioning

The yield on the Fund was virtually unchanged on the quarter and excess yield versus the benchmark compressed slightly. Duration remained shorter than the benchmark, as inflation remains a concern. Credit quality continues to be in line with the benchmark.

The Fund's sector weightings did not change significantly in the fourth quarter. Within the Finance sector, we sold some of our U.S. dollar insurance holdings to buy U.S. banks that showed improving relative value. In Canadian dollars, we sold some of our higher beta debt including hybrids in favour of higher quality pensions and U.S. bank maple debt.

The Fund continues to favour the value found in the 20-year part of the yield curve relative to the more common 10-year and 30-year points of the curve, but to a lesser degree this quarter. This quarter saw us moving some of our exposure from the seven to 20-year belly of the curve to invest more funds in five-year and 30-year debt to take advantage of the rise in five-year yields that accompanied rising expectations for more significant central bank rate hikes.

The credit quality of the overall Fund did not significantly change this quarter.

The Fund's foreign weighting continued to decline from 17.4% at the end of the third quarter to 15.3%, as we rotated out of U.S. dollar corporates and U.S. treasuries back into Canadian corporates and federals. Tighter U.S. credit spreads and a lower hedging benefit have combined to make U.S. debt less appealing. The portfolio hedges its U.S. dollar bonds using a cash flow swap to minimize the fund's exposure to changes in U.S. currency and U.S. interest rates.

SUN LIFE CORE ADVANTAGE CREDIT PRIVATE POOL MONTHLY SNAPSHOT : **SERIES A** | **SERIES F**

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[1] Bank of Canada, Assets and Liabilities Report. [2] Statistics Canada, International Transactions in Securities. [3] BMO Capital Markets.

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