

Market Highlights

Canadian and US bond yields continued their lengthy periods of relative inactivity that began in March, despite volatile economic data. Investors have clearly decided that, for the time being, they will not be swayed by real-time information that shows no apparent trend. Since peaking on March 12th, five-year Canada yields have hovered between 0.86% and 1.04%, while five-year US Treasury yields peaked on March 31st and have since hovered between 0.77% and 0.94%. Two-year yields, in both Canada and the US, have largely been range-bound since the beginning of the pandemic, trading in 17 and 12 basis points ranges, respectively following the March 2020 declines.

Although Inflation has increased – the most recent Canadian and US headline CPI are running at 3.4% and 4.2% respectively – so much uncertainty surrounds the hole in employment, the likelihood of supply rebounding, global demand, and the lasting effects of the pandemic as to question the durability of the higher inflation numbers. For now, investors have mostly shown a willingness to follow the central banks and look past the current rise of inflation.

For their parts, the Bank of Canada and the Federal Reserve have been careful to signal status quo with respect to interest rates while adjusting policy through their bond purchase programs. The Bank has already tapered the par market value of Canada bond QE purchases (but has increased the average duration/term), while the Fed has only discussed discussing tapering. Both, the Bank and the Fed have concluded corporate bond purchases – the Bank having ended the Corporate Bond Purchase Program on April 2nd (less than \$200 Million was purchased), and the Fed having said this past week that it will begin selling its holdings from the Secondary Market Corporate Credit Facility in an orderly fashion (there is \$14.7 Billion in corporate bonds and corporate bond ETF's on the Fed's \$8 Trillion BS).

The corporate bond market is benefitting (as are equities) from gradually improving economic data combined with expectations for stable interest rates. Canadian investment grade yield spreads have narrowed to levels last seen prior to the credit crisis and high yield spreads are close to the narrowest levels of the last 20 years despite near record leverage and record issuance year-to-date.

Outlook and Strategy

For those countries with access to vaccines, distribution and penetration have become the dominant pandemic concerns. Unfortunately for those countries without access, cases and deaths remain the dominant issue. The US has the enviable position of having excess vaccine supply, such that resistance and hesitance have replaced distribution as the most important concern. In Canada, we are still vaccinating at close to supply, but hereto, we are beginning to bump up against those not wishing to be vaccinated. So far, the US, the UK, Israel and a few others have regained a semblance of normal life without achieving herd immunity – it remains to be seen if that will last. As ever, variants of concern are emerging as the new face of the pandemic.

Widespread vaccinations in the US should permit more economic activity throughout the rest of the year, with Canada – given the rapid increase in available doses – not far behind. A European recovery (despite domestic vaccine production) will lag, exacerbated by lockdowns and slow vaccination rates. In much of the developing world (China being a notable exception) the virus and mutations, which continue to surge with substantial vaccination still way off, will impart an economic impact both locally and globally.

We believe that neither the Fed nor the BoC will provide any indication of a rate increase which will continue to pressure yield curves to flatten – we have already seen some flattening and should see some more. Furthermore, while inflation will temporarily be underpinned by weak prices from a year ago and supply/demand imbalances, we do not believe a secular rise is imminent.

Throughout the pandemic the credit markets have benefitted from the lowering of sovereign yields and central bank commitments to maintain easy monetary policy and market liquidity. However, there is still the question as to whether excess liquidity can solve stretched credit metrics and ultimately, solvency. In the domestic market, which is dominated by investment grade credits, leverage metrics remain elevated, but debt servicing is healthy and refinancing risks are not a near-term threat, even amongst the lowest rated names.