Focused Fixed Income

July 2021

Market Highlights

Although bond yields began to turn downward in June, it was not until July that a firm downtrend was established. 10-Year US Treasury and Government of Canada yields declined by 25 and 19 basis points, respectively during the month, resulting in declines of 52 and 41 bps, respectively from the post-pandemic peaks of March to month-end. The entire move has been led by the decline of real yields – 10-year TIPS and RRB's have fallen by 59 and 35 bps, respectively from their respective March and April peaks to month-end. The collapse of real yields – 10-year TIPS and RRB's are now at -0.56% and -1.10%, respectively – suggests a significant revaluation of the lofty growth expectations held in Q1.

The St. Louis Fed's 5-Yr/5-Yr Forward Inflation Expectation Rate Index is now at 2.25%, not having fallen significantly from its May peak of 2.37%; while a similar index for Canada (calculated by Cidel) now at 1.54%, having declined by 27 bps from its June peak. The significant rise of inflation expectations in the US from pre-pandemic levels – the index was at 1.5% at the end of February 2020 – suggests there is still a substantial contingent of investors expecting inflation to trend higher (despite the Fed's protestations otherwise). In Canada, forward expectations are not that far off pre-pandemic levels – 1.62% (for our computed index) – suggesting a more benign outlook. However, it should be noted that the Canadian RRB market is not as accurate an indicator of inflation expectations, as is the TIPS market, given its relative illiquidity. Nonetheless, Canadian growth and inflation have lagged the US primarily because the virus's spread and lockdowns have lagged.

While US economic data showed some improvement in July, the data remains volatile and unclear. July payroll gains were strong, but a strong post-third wave trend still needs to be proven. The US labour force participation rate remains well below pre-pandemic levels (61.7% versus 63.4%) despite jobs being relatively easy to get (the Conference Board's Jobs Hard to Get index is at an all time low of 10.5). Many are blaming the disappointing US recovery on the difficulty finding workers. Not surprisingly inflation pressures persist, with US inflation data broadly ticking higher. In Canada, employment and inflation are also higher, but the Canadian economy is more difficult to discern, given much of the country has only recently emerged from lock-down.

The corporate bond market is benefitting (as are equities) from gradually improving economic data amidst a backdrop of falling bond yields and supportive monetary policy. Issuance during the month was $12.3 Billion and now on pace to surpass last year's near record tally. Whereas domestic investment grade yield spreads are nearing pre-pandemic levels, US high yield spreads are close to the narrowest levels of the last 20 years despite record issuance, elevated leverage and significantly weakened debt structures.

Outlook and Strategy

The virus remains the wildcard for the bond market. Although most developed countries are progressing through vaccination programs, given the reality of vaccine hesitancy and resistance, the fact that much of the developing world is not vaccinated, and the rapid transmission of the Delta variant, we believe that the virus will remain a threat to economic growth for some time. The bond market had gotten ahead of itself at the end of Q1, with lofty growth expectations, despite much of the world still facing much economic uncertainty. Expectations have been appropriately paired back and we do not expect to see a large rebound in real yields in the immediate future.

As we expected, yield curves could not retain their steepness from the end of Q1, without some hint of rate increases which were not forthcoming from the Fed or the BoC. Much of the remaining steepness of the yield curve relates to inflation expectations which remain high. While inflation will temporarily be driven by supply/demand imbalances and underpinned by weak prices from a year ago, we do not believe a secular rise is imminent. Although we expect inflation expectations to ultimately decline, this may take some time.

Credit conditions have remained favourable given the economic rebound and continued easy financing conditions. However, cost pressures, the gradual withdrawal of monetary and fiscal stimulus, a slowing recovery, and the elevated leverage and weakened debt structures amongst lower rated credits leaves yield spreads of higher risk credits more vulnerable to widening from post credit crisis lows. In the Canadian market, which is dominated by investment grade credits, leverage metrics are similarly elevated, but debt servicing metrics are healthy and refinancing risk is not a near-term threat, even for the lowest-rated issues. The portfolio has good liquidity and is well positioned to capitalize on relative value and yield enhancement opportunities.

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