Focused Fixed Income

September 2021

Market Highlights

Lofty growth forecasts were pared back during the quarter due to supply disruptions and signs that inflationary pressures were weighing on consumer and business sentiment. Disappointing US employment numbers, regional delta variant outbreaks and an unexpected contraction in Q2 Canadian Real GDP (-1.1% annualized) added to concerns. The softer growth backdrop, political developments and August US CPI data, suggesting inflation pressures were peaking, resulted in benign September monetary policy decisions from both the Fed and the Bank of Canada. The Fed suggested that tapering asset purchases could end around the middle of next year, while being careful to give itself lots of latitude on the start date.

US Treasury and Government of Canada yields fell in July, traded in a narrow range through early September, rising to the end of the quarter – 10-year yields rose by 7 and 12 basis points, respectively. The US yield curve bear flattened while the similar Government of Canada curve bear steepened, reflecting an increase in US short-term rates which had lagged higher short-term Canadian rates. Investors have been anticipating more aggressive action from the Bank of Canada. US and Canadian overnight indexed swaps are pricing in one and two hikes in 2022, respectively.

Credit conditions remained favourable for provincial and investment grade corporate credit, but investors remained cautious, continuing to reach for yield but preferring short and mid-term issues. Provincial yield spreads benefitted from diminishing concerns over supply as provincial fiscal forecasts, which were initially based on very conservative assumptions, came in well above expectations. Domestic investment grade credit benefitted from positive corporate earnings, ratings upgrades and continued easy monetary policy. Volatility was more acute in the high yield market which saw periods of primary market disruptions. Overall, provincial and corporate yield spreads tightened but remained within narrow ranges over the quarter.

Portfolio Activity

Exposure to short-term provincial and corporate debt was increased through a reduction of long-term provincial debt.

What Worked In the Quarter

The portfolio, which had a duration that was slightly shorter than that of the benchmark, benefitted on a relative basis from the rise in yields. The portfolio also benefitted from overweight exposure, on market value and duration weighted basis, to provincials and corporates given narrowing credit spreads and additional yield pickup. The provincial concentrations in Ontario and Alberta outperformed on significantly improved fiscal projections and reduced supply expectations. The corporate holdings, which were overweight short and mid-term credits in lieu of long bonds, benefitted from bull steepening of the credit spread curve (increasing spread with term). Overweight positions in outperforming issues of senior domestic bank, telecom and pipeline debt also benefitted performance. The portfolio also had no exposure to underperforming airport, retail, subordinated bank, utility and pension debt.

What Didn't Work In The Quarter

The portfolio has no exposure to lower-rated credit (BBB mid and lower) or issues in real estate, mortgage finance and hybrid debt which outperformed.

Outlook & Strategy

We expect economic data to remain volatile while the pandemic continues to infect the economy leading investors to act cautiously. We believe market pricing offers some opportunity for tactical positioning but expect yield curve moves to be relatively modest. It may take more time than investors think for inflation expectations to dissipate, thus placing some near-term upside risks to breakeven inflation rates and nominal yields. On the other hand, there is a risk that growth disappoints, leaving room for real yields to decline, despite already being at very low levels. Ultimately, we see near-term risk of higher nominal yields, with the potential for reversal further out.

Consistent with the potential for higher inflation expectations and recognising that investors are not being particularly well-rewarded for investing further out the yield curve, the portfolios are positioned with slightly shorter-than-market duration, with a slight bias for yield curve steepening. Should yields rise, either through higher inflation expectations or growth surprises, we will look to take advantage of tactical opportunities.

Credit conditions have remained favourable for most industries given the economic recovery and continued easy financing conditions. However, cost pressures, loss of economic momentum, gradual withdrawal of fiscal stimulus, elevated leverage, and weakened debt structures amongst lower rated credits leave yield spreads of higher risk credits more vulnerable to widening from post credit crisis lows. In the domestic 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.

Focused Fixed Income

September 2021

Disclaimer

This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The information contained in this document has been compiled by Cidel Asset Management Inc. from sources believed to be reliable, but no representations or warranty, express or implied, are made by Cidel Asset Management Inc. as to its accuracy, completeness or correctness. The opinions expressed are as of the date of this publication and may change without notice and are provided in good faith, but without legal responsibility. Lorica Investment Strategies is a trade name of Cidel Asset Management Inc. Cidel Asset Management Inc., carrying on business as Cidel ("Cidel" is a registered trademark) is registered as a portfolio manager, investment fund manager and exempt market dealer in Ontario. Cidel is also registered as a portfolio manager and exempt market dealer in the provinces of Alberta, British Columbia, Manitoba, New Brunswick, Newfoundland and Labrador, Nova Scotia, Prince Edward Island and Saskatchewan. In Quebec, Cidel is registered as a portfolio manager, investment fund manager and exempt market dealer. This document may not be reproduced, distributed or published by any recipient hereof for any purpose.

Cidel
Asset Management