



## Short-Term Bond

October 2021

### Market Highlights

October's rise of two-year Government of Canada yields was the largest basis point move at 56 basis points since March 2002 (when the Bank of Canada was expected to tighten policy after a period of substantial stimulus following 9/11). Two-year Treasuries rose by a comparatively small 22 bps, owing to more modest policy expectations from the Fed. However, unlike the move in the first quarter of this year when the long-end dominated the rise in yields (10-year Treasuries and Canadas rose 83 and 88 bps, respectively, while 2-years were essentially flat), the rise of short-term yields was not matched in the long end – US and Canada 10-year yields rose by 6 and 21 bps, respectively. So, while headlines would suggest the bond market was severely hurt by rising inflation expectations, this was not exactly true with the Bloomberg US Aggregate flat for the month, while the FTSE Canada Universe Index was down 1.05%. In contrast, the Short-Term US Aggregate and the Canadian Short Term Bond Index returned -0.49% and -1.08%, respectively.

The Bank of Canada contributed to investor fears through its posturing in its fall Monetary Policy Report, where it expressed concerns that the output gap would disappear by the middle of next year due to tightening labour markets. The Bank stuck to its messaging, as has the Fed, that inflation would be transitory as supply/demand imbalances and volatile energy would eventually dissipate. Market overreaction has the overnight indexed swap (OIS) and banker's acceptance futures (BAX) markets pricing in four BoC (25 bps) hikes by the middle of next year. In contrast the Federal Reserve is expected to raise rates (25 bps) once over the same period. Central bank tightening expectations globally have reduced growth forecasts and resulted in a decline of nominal yields driven by the fall of all-ready low real yields.

For the month, short corporate bond yields moved higher by 41 bps, driven by the rise of underlying short Government of Canada yields. While corporate spreads narrowed overall, the narrowing in short-term spreads was marginal at 2 bps, compared to long corporate spreads which narrowed by 6 bps. As a result, short-term corporates performed in-line with short-term Canadas for the month (both returning about -1%), whereas mid and long-term corporates outperformed similar term Canadas (30 and 75 bps, respectively).

### Outlook & Strategy

We expect the economic recovery to remain disappointing even as conditions surrounding the pandemic improve. Supply/demand imbalances, high energy prices and labour market dislocations will take time to normalise, keeping economic data volatile and unpredictable; policymakers will proceed cautiously. Rising inflation and tight labour markets have, however, prompted investors to expect excessive monetary policies from central banks. We believe the short-term (one to five-year) Canadian bond market is pricing in too much tightening from the Bank of Canada. In addition, longer-term real yields, which have fallen in response to tighter policy and reduced growth expectations are likely to reverse some. Thus, in the near-term, we expect the Canadian yield curve to re-steepen, providing opportunity for tactical positioning. Further out, inflation expectations should dissipate, placing some downside risks to breakeven inflation rates and nominal yields.

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 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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