Focused Fixed Income

November 2021

Market Highlights

Just as bond investors were beginning to gain confidence in pricing some semblance of return to normalcy in monetary policy and inflation expectations, Omicron struck and reminded investors that they are not in charge. During November, two and three-year yields, that had been increasing since the summer, continued to rise as expectations mount that the Fed's tapering guidance will translate into policy rate hikes next year. However, further out the yield curve, five-year yields halted their rise with news of the Omicron variant, while ten-year yields began to follow the trajectory of long Treasury yields, that have been trending downwards since mid-March. It appears that the market is comfortable pricing in some tightening from the Fed in the face of higher inflation but is still confident that inflation will ultimately fall as growth slows over the next few years.

The Canadian yield curve has underperformed the Treasury curve this year as investors have priced in a stronger Canadian economy (on the back of more relative job gains) and stronger action from the Bank of Canada. Canada 5-year yields have risen roughly 70 basis points since mid-year versus about 40 bps for Treasuries. Some of the recovery optimism that surrounded the US bond market earlier in the year, is now gone. US and Canada long-bonds are well below their spring peaks, also true for 10-year Treasuries (~ 25 bps lower) but not Canadas (only ~ 5 bps lower). The futures and swap markets are pricing in 5 hikes from the Bank of Canada versus 2½ hikes from the Federal Reserve over the next twelve months.

Headline inflation is running extremely high and is dragging the core numbers higher as well – both the US PCE deflator and Core CPI are running over 4%. However, there are signs that transitory forces of the current rise of inflation are dissipating – for example commodity prices (Bloomberg Index) and shipping costs (Baltic Dry Index) have both fallen from their peaks and there is anecdotal evidence that supply chain problems are also falling. More troubling however, is the persistent shortage of workers – job openings (JOLTs survey) are through the roof which are contributing to noticeably higher wages year-to-date (Employment Cost Index).

For most of the month credit markets were constructive, with spreads grinding tighter despite a November record for new issuance. However, the reality of higher policy rates next year and the emergence of Omicron late in the month punished risk assets, such that Canadian investment grade yield spreads widened by 8 bps for the month with the credit spread curve flattening. Shorter-dated lower beta issues underperformed as investors enlisted the most liquid areas of the market to reduce credit exposure into widening yield spreads.

Outlook & Strategy

The virus is once again front and centre to future growth prospects due to the arrival of Omicron and generally poor global vaccination distribution. While some transitory inflation factors have improved, other potentially more secular factors are of greater concern, which will keep policy makers vigilant yet cautious. We believe the short-term (one to five-year) Canadian bond market is pricing in too much tightening from the Bank of Canada, while 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.

Given our forecast for the economic recovery to fall short of market expectations, we anticipate that the market will settle into a cautious reach for yield environment. Credits that are higher-levered and have weak liquidity profiles will see yield spread widening, particularly for longer-term credit where term premiums have notably increased. Unlike past "reach for yield" periods, due to deteriorated credit metrics and less likelihood of further monetary and fiscal stimulus, we expect to see less momentum driven trade and greater differentiation of spread performance amongst lower rated, higher-beta and illiquid credits. The portfolio has good liquidity and is well positioned to capitalize on relative value and yield enhancement opportunities.

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