Focused Fixed Income

December 2021

Market Highlights

Bond markets finished off a poor year on a relatively strong note, with yields across the curve rallying through December. For the quarter, Government of Canada two and five-year yields rose by 42 and 15 basis points, respectively while ten and thirty-year yields fell by 8 and 31 bps, respectively. US Treasury yields followed a similar pattern, but underperformed, with 2 and 5-year yields rising by 46 and 30 bps, respectively, 10-years basically flat, and long bond yields falling by only 14 bps. Both Canadian and US yield curves flattened significantly during the quarter: 73 and 60 bps, respectively.

During October, investors increased expectations of higher policy rates which pushed up shorter-term yields substantially, while during December, investors reduced growth expectations which pushed down real long-term yields. Investors were pricing in more aggressive action from the Bank of Canada with Overnight Indexed Swap markets indicating around five hikes from the Bank over the next 12 months as of year-end, while expectations for the Fed were for around three hikes over the similar period.

Perhaps the biggest developments during the quarter from a bond market perspective were the indications from both the Fed and the BoC that inflation could no longer be categorised as a transitory phenomenon that would be imminently disappearing – valid given that core CPI has been following the lead of higher headline CPI and wage growth has clearly been gaining momentum. In addition, both central banks indicated that they would be ending their QE programs. Although neither bank has yet raised policy rates, investors extrapolated the guidance as a warning shot signalling higher rates in the new year.

Portfolio Activity

Given corporate spread widening to the highest levels of the year, the relative underweight exposure to corporate credit (on a duration-weighted basis) was increased to an overweight through the purchase of mid-term senior bank debt. The duration, yield curve, sector and high credit quality biases of the portfolio were maintained.

What Worked In The Quarter

Lower long-term government yields and reduced provincial issuance acted as a tailwind for long-term provincial credit spread narrowing which benefitted the portfolio as it had an overweight exposure (on both market value and duration weighted bases) to long-term provincials. Provincial concentrations in Alberta and Ontario outperformed on significantly improved fiscal projections and reduced borrowing needs. Corporate sector and issuer composition was also a positive contributor to performance as the portfolio had an overweight of outperforming issues of telecom, insurance and pipelines. Provincial and corporate overweight's (on a market value basis) provided additional yield.

What Didn't Work In The Quarter

The portfolio was positioned conservatively, with a shorter relative duration and an underweight in long-term debt in recognition of near-term upside risks to breakeven inflation rates and nominal yields. Reduced growth expectations led to lower real long-term yields and resulted in a flattening of the yield curve.

Outlook & Strategy

While Omicron is clearly a significant development in terms of the pandemic, it remains to be seen how significant the path of economic growth and the trajectory of bond yields will be affected. We expect to see some impact on the economy, but we have previously witnessed that similar circumstances of reduced social activity have not led to a material slowdown in economic growth. Bond investors have already reversed their knee-jerk pessimism in response to Omicron, raising yields during the first week of the new year. We think that inflationary pressures could be exacerbated, as supply chains remain under pressure and labour force pressures continue. Nevertheless, the Canadian bond market appears to be pricing in too much tightening from the Bank of Canada, which could result in bull steepening of the yield curve (lower short-term yields), as expectations are reduced. Further out, inflation expectations should dissipate, placing some downside risks to breakeven inflation rates and nominal yields. The portfolio is currently positioned defensively for a steeper yield curve.

We expect bond investors to continue to cautiously reach-for-yield as the economic recovery ultimately falls short of market expectations, tempering monetary policy actions. Credits that are higher-levered and have weak liquidity profiles will see yield spread widening, particularly longer-term credit where term premiums are low. 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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