



## Short-Term Bond

December 2021

### Market Highlights

Short-term government yield curves significantly bear flattened during the quarter as investors increased rate hike expectations. For the quarter, Government of Canada, two, three and five-year yields rose by 48, 42, 43 and 15 basis points. US Treasury yields followed a similar pattern, but underperformed, with 2, 3 and 5-year yields rising by 46, 45 and 30 bps, respectively.

During October, investors increased expectations of higher policy rates which pushed up shorter-term yields substantially. 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. As a result, while the Canadian and US five-year yield were nearly equivalent, US one-year yields ended the quarter 40bps below that of Canada.

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 the increase in short-term corporate yields, purchases of four-year senior bank and information services were made through the reduction of shorter-term bank debt and cash from coupon payments. The yield curve, sector and credit quality biases were maintained.

### What Worked In The Quarter

Corporate sector and issuer composition was a positive contributor as the portfolio had an overweight of outperforming issues of telecom, insurance, consumer staples, pipelines and non-DSIB senior bank debt. Provincial concentrations of Alberta and Ontario outperformed on significantly improved fiscal projections and reduced borrowing needs. Provincial and corporate overweight's provided additional yield.

### What Didn't Work In The Quarter

The portfolio was positioned conservatively, with a short relative duration and no exposure to five-year debt in recognition of near-term upside risks to breakeven inflation rates and nominal yields. Increased rate hike expectations resulted in bear flattening of the short-term 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 short-term 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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