Short-Term Bond

February 2022

Market Highlights

It seems so long ago that the dominant issue facing investors was the pandemic and lockdowns. Of course, the pandemic morphed into rising inflation as supply chains, energy and workers all found themselves in short supply. Central banks reacted predictably and sternly, unwinding the temporary inflation theme, replacing it with a rising-rate playbook. And while the initial phase of the pandemic created extreme volatility, treasury and central bank policy had allowed investors to generally take the unfolding environment in stride. We imagined, at the time, that the credit crisis served as a rehearsal for the pandemic. Now, the markets are facing a new bout of uncertainty created by the Russian invasion of Ukraine. For the most part, markets have been calm, not overreacting to information, but punishing those assets most directly related. To a significant extent, investors have been willing to accept the narrative that western economies will be significantly insulated. However, with each day the war continues, additional western actions imperil the global economy, particularly those regions most exposed to Russia.

Although only the US has, so-far, indicated that it will be sanctioning Russian oil and natural gas supplies, difficulty financing Russian oil exports and self-policing by certain importers, have already reduced Russian exports. The potential for other sources of supply to come on-stream – e.g., Iran and Venezuela and more fracking, remains, but is uncertain and will not likely alleviate pressures in the short-run. Supply-side inflation pressures that have emerged from the pandemic will only be exacerbated by the war given the rise in oil and natural gas prices and the impact of the war on other commodities.

Yields curves have bear-flattened with front-end yields rising to reflect expectations of higher rates from central banks. The Bank of Canada has already ratified expectations with its first tightening on March 2nd; the Federal Reserve for its part has clarified that it too will be raising rates shortly. Market expectations are for policy rates rising to around 1.5% for both the Bank and the Fed over the next year. During February, longer-term yields reversed some of the rise from January, but yields have been volatile – as investors try to reconcile rising inflation, demand pressures, higher interest rates and the war in Ukraine. A difficult mix to navigate.

Outlook & Strategy

While pandemic-related factors impacting economic growth continue to dissipate, the Russia-Ukraine war has introduced a new set of concerns that will hinder growth and aggravate inflation. We expect supply-side inflation to be stubborn. That being said, bond yields have risen in anticipation of sustained central bank rate increases that will gradually slow demand-side pressures. The hope is that central banks will be able to raise policy rates slowly enough for supply pressures to abate and inflation to come down before tipping the economy into recession. However, monetary policy will require a delicate balancing act as wage pressures are material and run the risk of embedding themselves in the economy if left to fester.

We expect bond investors to continue to cautiously “reach for yield”. Credits that are higher-levered and reliant on easy financing conditions will see yield spread widening, particularly those with longer maturities where term premiums are low. We expect to see less momentum driven trade and greater differentiation of spread performance amongst lower rated, higher-beta and illiquid credits.

The duration of the portfolio is around 2.5 years, but we will remain vigilant for slowing economic growth, in response to too punitive rate increases, that could ultimately drive yields lower and make credit markets more vulnerable. The portfolio has good liquidity and is well positioned to capitalize on relative value and yield enhancement opportunities.

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