



## Focused Fixed Income

March 2022

### Market Highlights

After years of watching the Fed be led by the market, the Board of Governors decided to take charge in the face of inflation numbers that have surged through the pandemic and have been further aggravated by the war in Ukraine. The rise in long-term inflation expectations have finally got the Fed's attention. At any rate, a radical adjustment to the rate and magnitude of policy rate increases, and indications that it would begin unwinding its balance sheet imminently, hastened the dramatic sell-off across the yield curve during the quarter – 2, 10 and 30-year US Treasury yields backed-up by 160, 80 and 54 basis points, respectively. The Bank of Canada matched the Fed with similar aggressive guidance, such that 2, 10 and 30-year Government of Canada yields rose by 134, 98 and 70 bps, respectively for the quarter.

Corporate yield spreads were volatile through the quarter, and ended the period wider, ensuring that corporate returns were weaker than government returns on a duration-adjusted basis. Predictably, investors had a risk-off response to the Russian invasion of Ukraine which dramatically widened yield spreads, but, as containment of the war and its economic impact became more apparent, yield spreads retraced much of the related widening.

There was no-where in the bond market to hide during the quarter, as the bear-flattening of the underlying government yield curves (short-term yields rose more than long-term yields) and wider yield spreads (from narrow levels) ensured that returns were weak across the asset class. The overall Canadian market returned -7%, with short-term bonds returning -3% versus long-term bonds, which returned almost -12%.

### Portfolio Activity

The portfolio was structured defensively on a duration, yield curve and sector bases. Coupons and issues of less than 1-year to maturity were reinvested into existing positions.

### What Worked in the Quarter

Performance benefitted from the portfolio's shorter duration versus the benchmark given the rise of yields. The portfolio's positioning for flattening with an overweight in short and long-term debt and underweight 7 and 10-year debt was also positive for performance given significant flattening of the yield curve. Long bond exposure was concentrated in provincial debt, with an overweight in Alberta, which was amongst the few credit issuers that experienced yield spread narrowing. The overweight in credit also provided additional yield to the portfolio.

### What Didn't Work in the Quarter

The portfolio's corporate term distribution, which was positioned conservatively with overweights in the short and mid terms, was negative for performance given the bear flattening of the corporate credit curve.

### Outlook & Strategy

The crosscurrents impacting the bond market are many, but inflation is paramount. We expect monetary policy to tighten until inflation is brought under control and the Fed regains credibility. Unfortunately, supply-chains and commodity supply are problems that will negatively impact both growth and inflation for the foreseeable future; while labour markets, which have tightened quickly, are at risk of precipitating a wage-price spiral. Ultimately, long-term inflation expectations, which have risen, will remain top of mind for policymakers, until they show signs of slowing.

We think the Fed and the Bank of Canada will raise rates and empty their balance sheets so long as inflation remains high and real yields abnormally low. The yield curve is at risk of steepening, before re-flattening, to reflect an economy not yet ready to materially slow. Eventually, we expect an inverted yield curve (Fed Funds to 10-years) to signal an impending slowdown, maybe even recession, but we are not there yet. The abrupt flattening of the (2-10's) yield curve is perhaps a little premature.

With yield spreads still relatively narrow and a slowdown not yet in sight, we will maintain the portfolio's overweight in corporate bonds, but with high quality and mostly short maturities. The portfolio has been positioned for yield curve flattening which accelerated during Q1. We think further flattening will be some time off and will look to take advantage of intervening curve volatility. The first quarter's sell-off was dramatic, and we expect to see a period of consolidation.



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