Short-Term Bond

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, 3, and 5-year US Treasury yields backed-up by 160, 155 and 120 basis points, respectively. The Bank of Canada matched the Fed with similar aggressive guidance, such that 2, 3 and 5-year Government of Canada yields rose by 134, 120 and 111 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

Given the increase in short-term corporate yields and on the back of concessionary short-term bank issuance, the portfolio's exposure to senior bank debt was increased and exposure to shorter-term consumer staples decreased. The duration, yield curve and credit quality biases were maintained.

What Worked in the Quarter

The portfolio's short duration versus the benchmark benefitted relative performance. The portfolio had concentrations in telecom, pipelines and information services which outperformed; and had no exposure to lower-rated, higher beta issues in real estate, subordinated bank debt, autos, retail and hybrid debt which all underperformed. The provincial exposure was concentrated in outperforming Alberta and Ontario debt. Also, the market overweight of credit provided additional yield to the portfolio.

What Didn't Work in the Quarter

The portfolio's credit overweight was negative for performance given the widening of short provincial and corporate yield spreads by an average of 5 and 36 bps, respectively.

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.

Short-Term Bond

March 2022

Disclaimer

This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The information contained in this document has been compiled by Cidel Asset Management Inc. from sources believed to be reliable, but no representations or warranty, express or implied, are made by Cidel Asset Management Inc. as to its accuracy, completeness or correctness. The opinions expressed are as of the date of this publication and may change without notice and are provided in good faith, but without legal responsibility. Lorica Investment Strategies is a trade name of Cidel Asset Management Inc. Cidel Asset Management Inc., carrying on business as Cidel ("Cidel" is a registered trademark) is registered as a portfolio manager, investment fund manager and exempt market dealer in Ontario. Cidel is also registered as a portfolio manager and exempt market dealer in the provinces of Alberta, British Columbia, Manitoba, New Brunswick, Newfoundland and Labrador, Nova Scotia, Prince Edward Island and Saskatchewan. In Quebec, Cidel is registered as a portfolio manager, investment fund manager and exempt market dealer. This document may not be reproduced, distributed or published by any recipient hereof for any purpose.

Cidel
Asset Management