LORICA

Short-Term Bond

April 2022

Market Highlights

There was more punishment for bond investors in April as markets continued to digest the reality of persistent inflation pressures and the difficulty central banks are facing to tame them. Nominal yields across the curve rose to reflect growth that is not quickly faltering and inflation that is not quickly dissipating. However, in contrast to Q1, April was mostly about the rise of long-term real yields, which rose to positive territory after spending most of the pandemic below zero. However, despite the continued rise of consumer price inflation, inflation expectations did not change materially during the month (long-term inflation expectations rose substantially during March). The US and Canadian short term (1-5 years) markets returned -1.00% and -0.92% in local currency terms, respectively in April, contributing to the year-to-date returns of -4.42% and -3.87% for the Bloomberg US 1-5Yr Gov/Credit and FTSE Russell Canadian Short-Term indices, respectively, which is the worst start to the year since the beginning of the eighties.

Returns across most security markets have been hurt this year as investments face a myriad of risks which central banks cannot easily suppress. Bond and most equity markets have suffered from the abrupt rise in yields (notably, commodity markets and equity markets oriented to commodities, are outliers, having generated positive returns) as central banks are being forced to immitigably raise policy rates for the first time in decades. Both US and Canada yield curves are now pricing-in 200 basis points of rate increases over the next twelve months, a significant increase over the 75 bps that was priced-in at year-end. During previous tightening cycles the goal was to normalize rates, this cycle the modus operandi is squarely to stem inflation.

Coming out of the pandemic, households are in relatively good shape. Workers are employed (US and Canadian unemployment are at 3.6% and 5.2%, respectively) and unfilled jobs near record levels (7.1% in the US, 5.3% in Canada). Household balance sheets are in good condition, with households having saved during the pandemic (US and Canadian household debt to GDP are 77% and 108%, respectively) and having borrowed at extremely low rates. However, wage increases (ECI is running at 4.7%) cannot keep up with surging inflation, and borrowing rates are now much higher.

Outlook & Strategy

The Fed and the Bank of Canada are fighting mostly supply-side inflation with demand-side tools. Commodity supply and global supply chains have not recovered from the pandemic and been further aggravated by the war and other trade frictions, thus resulting in significant price increases for raw materials and manufactured goods. North American labour supply has similarly not recovered from the pandemic, with many industries struggling to fill positions. Some of the labour shortage can be traced to the pandemic – e.g., lower participation rates, decreased immigration, and graduation, while some can be traced to underlying demographic trends. Nonetheless, the pressure on labour markets has resulted in wage increases that are threatening to spiral out of control.

Unfortunately for central bankers, the only tool at their disposal to slow inflation is to arrest demand by tightening monetary policy. Both, the Fed and the BoC have telegraphed quantitative tightening and policy rate increases that have rapidly translated to the yield curve. We would be surprised if either did not follow through. Nevertheless, we expect to see a period of consolidation, during which the yield curve should see some re-flattening. The risks to the market are substantial given the grips of inflation and tighter monetary policy and the pressure on labour markets. The economy will eventually slow as will inflation, but it is not clear to us whether the expected level of tightening will be sufficient to slow the economy or whether more will have to be priced-in? And will the tightening ultimately result in a recession?

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