LORICA

# What We Think…

March 2022

## A Market Full of Risks

The bond market is priced for a rapid increase of policy rates that will end with Fed Funds peaking at 2.75% next year. Investors are assuming that by then, the economy will have slowed, and inflation will have turned, allowing the Fed to end its policy action. Investors appear to believe that the Fed is impatient to reverse the pandemic-easing that took Fed Funds from 1.75% to near-zero in early 2020. Forward markets imply that the Fed tightening beyond the first 150 basis points (i.e., reversing the Fed Fund easing that took place just before the pandemic, from the prior tightening cycle peak of 2.5%) will be more gradual. However, with so much of inflation being driven by supply-side factors beyond the Fed's control, it is difficult to predict when and by how much inflation will subside. Labour markets are the largest lever the Fed has, and unemployment and wages will be key variables to watch. Ultimately, if inflation does not show signs of abating, irrespective of signs of a growth slowdown, we think additional increases will eventually be priced into the market. But, unlike the current environment, we would not expect additional tightening to be supported by the same amount of forward guidance from the Fed, suggesting that the short end of the yield curve will not adjust as quickly as during Q1.

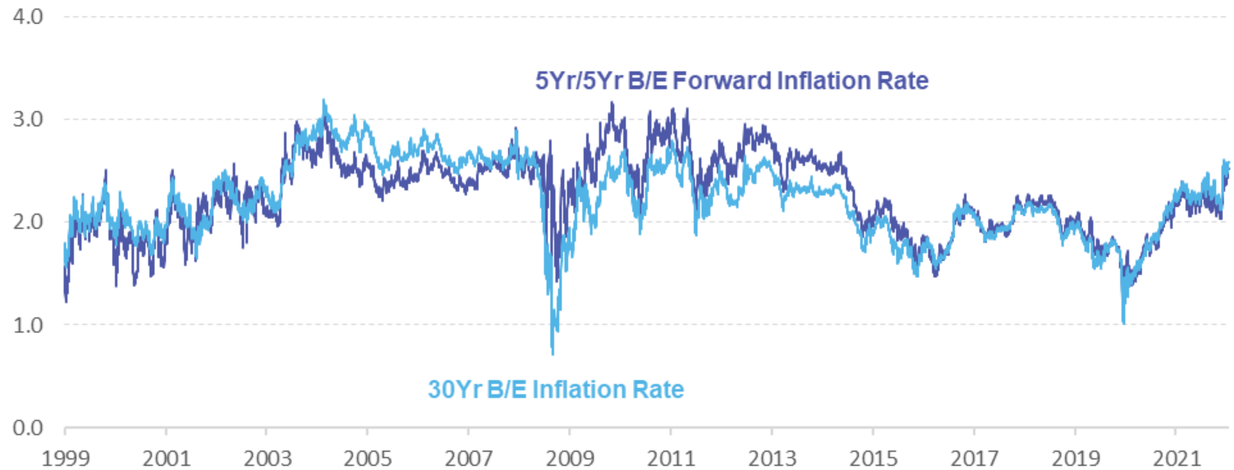
But what of long-term yields? If more tightening is priced into bond yields, we would expect yields across the curve to rise. We may not see such a flat yield curve below five years, but could easily see one beyond, albeit at higher levels. We would expect that a rise of the mid and long parts of the nominal yield curve would account for a rise of real yields. Currently, real yields are being distorted by a combination of very high current inflation, policy rate expectations, and some amount of supply-side correction to inflation. This is particularly true in the short-end where real yields are almost -2% (2-year TIPS), but also true for longer-term real yields which, until very recently, have been held well below zero.

Unfortunately, supply-side constraints, which emerged during the pandemic and have been aggravated by the war, have translated into inflationary pressures largely beyond the Fed's control. The supply of commodities has been affected by supply bottlenecks created by the pandemic, with energy prices additionally affected by the war. Goods have been in relative short supply with ongoing problems of lockdowns – China the most recent example – and broken supply chains. Finally, falling participation rates, reduced immigration and delayed graduation have contributed to labour shortages in North America. Consequently, we believe the Fed's ability to gain control over inflation revolves around its ability to reduce demand through tighter monetary policy. The pandemic has created uneven demand for goods and services, with the current environment particularly exposed to increased consumption due to healthier balance sheets, low unemployment rates, previously stimulative monetary policy, and pent-up demand.

As current inflation has risen, so too have long-term inflation expectations. After initially falling at the beginning of the pandemic, long-term expectations have been volatile (trading as low as 1%) but have risen to 2.5% more recently (see Figure 1). While 2.5% is not high by historical standards, these levels are the highest since 2014 and represents a challenge to the accepted deflationary world, that was present pre-pandemic and the Ukraine war. While many of the inflationary factors emanating from the pandemic will ultimately prove to be transitory, there are others that will likely not be. We believe that the war in Ukraine (and growing distaste for other trade counterparties) will precipitate a less globalized, less productive world that will contribute to higher secular inflation than would otherwise be the case. Consequently, we expect the market to continue to price a larger inflation premium into long-term nominal yields than before.

Since the 1990's investors have been able to use the TIPS market as a measure for real bond yields (the Canadian market uses RRB's). Prior to that, real yields were generally calculated as the difference between nominal yields and a measure for inflation expectations – current inflation was often used as a proxy (with all its inherent problems). While the TIPS market can trade "technical" (e.g., prices impacted by liquidity), it is a reasonable proxy for real yields. There are many factors that impact real yields along across the yield curve, but fundamentally, it is the supply and demand for capital for a specific term. (Of course, the market has ways of swapping fixed and floating rates, term, risk, etc.) At the beginning of the pandemic, long-term TIPS yields fell to historic lows (-1.20 for 10-year TIPS last November) but have since risen. The current environment is particularly complicated with respect to real yields, given: the effects of the pandemic and war on the economy; Federal Reserve rate hikes and balance sheet unwind; the level of government, business, and household borrowing; and investor flows.

**Figure 1: US Breakeven Inflation**




*Source: Bloomberg & Cidel Asset Management, March 2022.*

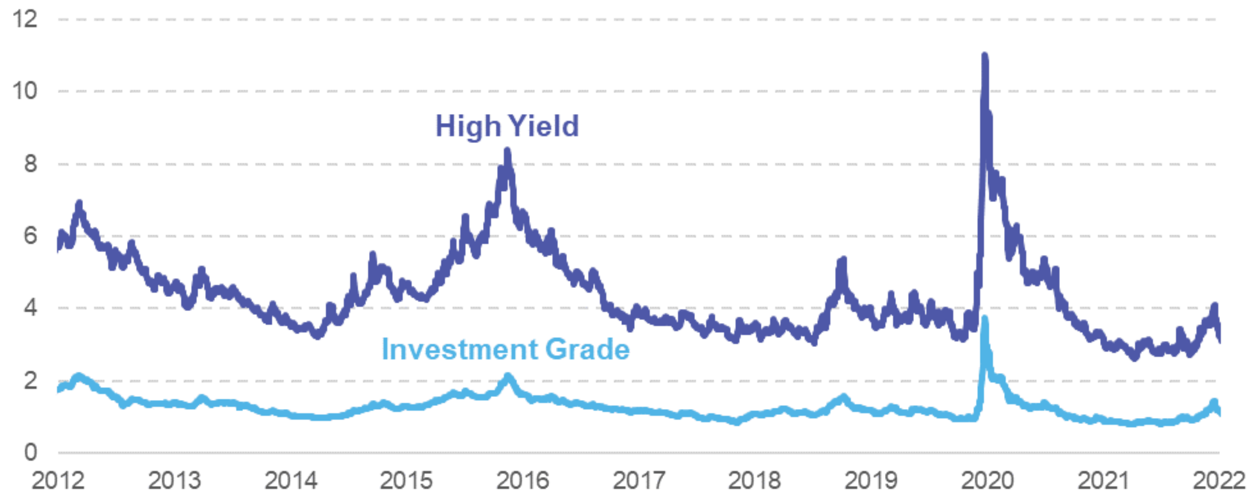
Forecasting growth through the pandemic has been particularly difficult with sickness and lockdowns having major implications for labour markets, supply chains and household consumption. The geographical disparity and volatility of growth has been pronounced, with China's current lockdowns the latest factor having a major impact. The war in Ukraine has also added to forecasting challenges, with sanctions complicating, already impaired, supply chains and depressing European growth. Over time we expect commodity supply will adjust to circumvent restrictions, at least partially. Conversely, it is reasonable to expect a surge in defence spending globally (according to The Economist, NATO could increase budgets by 25% or $US 80 billion a year to meet their 2% of GDP targets) which will boost growth in the same European countries that are suffering under sanctions.

Monetary policy has rarely been as hawkish as we are seeing today. It is one thing to see 50 basis point hikes, but another to have dot plots, supported by FOMC comments, that project 2.5% of rate increases over the next 12 months. (The only other tightening cycle under which dot plots had been used was during 2016-18 – their use began in 2012 – when the dot plots projected a slow and methodical rise of policy rates, and yields rose accordingly.) Although the Fed can adjust forward guidance, the current aggressive stance is unusual in the context of policy since the credit crisis. It is therefore not surprising that the yield curve has adjusted rapidly to the expected path of rising policy rates. Furthermore, by raising the spectre of a rapid unwind of its balance sheet, the Fed has added to the upward pressure on real yields across the curve.

The flow of funds in and out of the bond market is always difficult to assess given the wide range of market participants. Typically, destabilizing global events, such as war, result in some level of risk aversion and capital flow out of risk assets and into sovereign debt, particularly US Treasuries. Early in the pandemic there was a massive flight to safety that, with the help of quantitative easing, dissipated over time. The Russian invasion generated a more modest flight to safety, that has also largely dissipated, as investors have adopted the view that the war and its economic impact are likely to be contained. There has been some speculation that by employing sanctions on Russian exports and banning some Russian banks from SWIFT (global payment system), money would leave the US dollar and the US Treasury market – there has been no evidence of a significant move. On the other hand, low rates had already resulted in a long-term preference for shorter maturities, which the recent shift to tighter monetary policy has supplemented (according to the Chicago Board of Trade Commitment of Traders report).

Although credit spreads have widened through the first quarter, we have generally seen a controlled and limited scaling down of credit exposure. There was panic spread widening associated with the Russian invasion, but much of it has been retraced. Speculative grade credits have been the hardest hit, but spread levels are not far off pre-pandemic levels (see Figure 2). Tightening financial conditions have contributed to the move to higher credit quality, but in general, we don't think credit markets are pricing in a recession at the moment.

**Figure 2: US Investment Grade & High Yield Spreads**

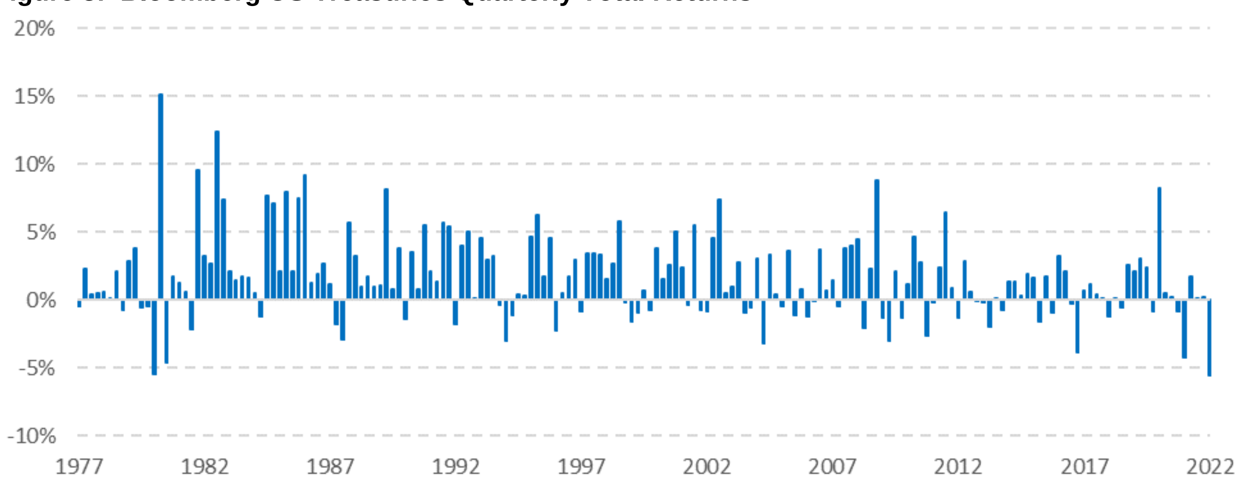



*Source: Bloomberg & Cidel Asset Management, March 2022.*

Provincial bonds have perhaps suffered more than should be expected, given their overall high credit quality. But the liquidity that many provincial bonds offer and their prevalence in many long portfolios means that they are a natural vehicle for unloading credit and duration risk quickly, leading to yield spread widening. Notably, Alberta yield spreads narrowed, overall, having benefitted from the rise of energy prices (a benefit that has not translated to the Canadian dollar, given the broader flight to safety of the Treasury market).

The portfolio has been positioned for a higher yields and flatter yield curve – with the Fed's encouragement, both have happened at unprecedented speed. Exceedingly high inflation and tight labour markets have focused central bankers and forced them to abandon a more measured approach, employed during the tightening cycles of recent memory. History would suggest a consolidation of yields is in order. However, the risk that the Fed could employ its massive balance sheet to force the yield curve higher and steeper looms large.

**Figure 3: Bloomberg US Treasuries Quarterly Total Returns**




*Source: Bloomberg & Cidel Asset Management, March 2022.*

We had upgraded the portfolio from a credit perspective, and to date there has been substantial credit spread widening. The economy has particularly poor visibility at this juncture, so we believe it makes sense to have reduced credit risk. We will, however, continue to look for opportunities to capitalize on yield spread volatility.

**The Bond Market in Context**

The bond market performance in the first quarter was the weakest since 1980. The Bloomberg US Aggregate Index returned a disappointing -5.93% in Q1, which was last eclipsed in Q3/80, when the index returned -6.56%. The devastation this year has been across the entire market, with Treasuries and Corporates returning -5.58% and -7.69%, respectively. The story is similar in Canada with federal, provincials and corporate bonds returning –5.55%, -8.57% and -6.45% (according to the FTSE Canada Universe Bond Index), respectively for the quarter (the relatively long provincial duration exaggerates the weak performance of the sector). Although we have seen periods of very poor bond market performance after 1980, it has generally not been across the entire asset class. For example, during the credit crisis, US corporate bonds returns -7.80% for Q3/08, while US Treasuries returned 2.30% over the same period. More recently, early on in the pandemic, the respective US corporates and Treasuries returns in Q1/20 were -3.63% and 8.20%, respectively.

In the 1980's when bond market returns were poor, there was significant quarter-over-quarter variation, with the Aggregate Index losing 8.71% in Q1 1980, rebounding 18.79% in Q2, before falling again in Q3. Looking back at that episode, the market suffered from volatility in underlying treasury yields which dominated the performance across the entire market – similar to what is plaguing the market today. Notably, from the 1980's onwards, yields have been in a downward trend, which has tended to cushion periods of weak performance, especially during episodes of widening yield spreads. The most notable exceptions, where markets declined broadly were in: Q4/16 (beginning of the Fed's 2017-18 tightening cycle), Q2/04 (high energy prices off low policy rates), and Q1/94 (rapid payroll growth), all when the Fed embarked on lengthy tightening cycles. The "Taper Tantrums" (Q2/13), when the market reacted to the announced end of QE rather than to rate hikes, was an exception to the norm, where poor bond market performance did not result from higher policy rates.

The overall US Treasury Market returned -5.58% for the quarter and -5.41 for the six months ending March (see Figure 3). The last time US Treasuries returned less than -5% over six months was in 2021 when yields rebounded from rock-bottom levels after the aggressive policy easing of the pandemic and lost 5.05% in the six months to the end of Q1. Prior to that, you must go all the way back to 1980 to find the last six-month loss for Treasuries. In 1980, the Fed raised the target policy rate to 20% in the face of spiralling inflation (the GDP Deflator reached 10%) – US Treasuries returned -7.02% for the six months ending February 1980. Notably, in both instances, US Treasuries had positive returns over the following quarter, 1.75% for the quarter ending June 2021 and nearly 15% for the quarter ending May 1980.

Cidel
Asset Management

**Gary Morris**, BASc, MBA, CFA
Head of Fixed Income