Short-Term Bond

May 2022

Market Highlights

The Bank of Canada and Federal Reserve delivered on their guidance by each raising overnight rates by 50 basis points, taking the targets for Fed Funds and the Bank Deposit Rate to 1% and 1.5%, respectively – we expect the target for Fed Funds to catch up with Deposit Rate in June. The bond market had already priced-in the 50 bps hikes, as well as additional hikes that will ultimately take rates to around 3.5% by year-end. Note that the market has priced in an additional 50 bps of tightening since May-end in a response to "still" surging inflation. Unfortunately, inflation is not showing signs of abating and investors are becoming impatient with the Fed (and the Bank of Canada's) responses, by pricing in more 50-bps tightening's.

As at the time of writing, both the Canadian and US yield curves have developed unusual convex shapes, such that two and thirty-year yields are almost at the same levels, but with mid-term yields higher by roughly 10 bps – close to the level that the market is expecting policy peak at one-year out. Five-year Canadas and Treasuries are both the highest parts of the yield curve at just over 3.5%. Our interpretation is that markets are reflecting the necessity of sustained policy rate increases followed by the inevitability of a significant slowdown, if not recession.

Clearly, the dominant theme facing capital markets is inflation. There is a backlog in household spending which is being propelled by improved household savings, delayed consumption due to the pandemic, the overhang of historically low financing costs and wage gains. While on the supply side, there are commodity shortages, fuelled by the pandemic and the Ukraine War, broken supply chains aggravated by China's lockdowns, and many unfilled jobs. The intersection of household demand and the supply of goods and services is resulting in inflation of historic proportions. Desperately, central banks are trying to rein it under control, but demand appears resilient.

Outlook & Strategy

We would be surprised if the central banks do not follow through on magnitude of their guidance for policy rate increases. However, we are unsure of the ultimate path of policy rates, as inflation and central bank creditability will continue to put pressure on central bankers to up the ante. The current bout of inflation is clearly pulling central banks out of the playbooks they have been using in recent tightening cycles and forcing them to rethink their gradualist approach. We think the ultimate level of policy rates will largely depend upon the resilience of consumer demand in the face of higher rates and higher costs. We do not place too much faith on supply-side factors normalising.

Yields have adjusted higher in a hurry, but we could easily see more volatility if inflation persists, but signs of a slowdown emerge. Unfortunately, the effect of the pandemic continues to distort economic data, which will make it hard to discern obvious trends. We will be watching the labour markets closely for reversals of the recent trends of lower unemployment and greater job openings, and for further wage gains as pay increases migrate from new hires to existing employees.

The portfolio is positioned such that the corporate exposure is predominantly in the front part of the short (1 to 5-year) yield curve, with the balance in provincial bonds. We have reduced the exposure to more vulnerable credits in the face of higher yields and a significant economic slowdown.

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