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Focused Fixed Income

June 2022

Market Highlights

North American bond markets continued their sell-off in Q2, as US and Canadian sovereign yields rose across the curve. In the US, the yield curve steepened slightly, with 2 and 30-year yields rising by 62 and 74 bps, respectively. In Canada, the converse happened, with 2 and 30-year yields rising by 81 and 75 bps, respectively. At quarter-end the Canadian yield curve was noticeably inverted as demand for long Canadian dollar bonds - particularly provincials – continues to push long Canadian yields relatively lower. However, both US and Canadian yield curves are generally extremely flat, as investors paint the picture of aggressive monetary policy and high inflation, followed by more gradual easing of both policy and inflation.

The FTSE Canada Universe Index returned -5.66% during the quarter to end the first six months of the year at -12.23% – the worst six months period on record, with the next worse performance occurring in 1981. The US Bloomberg Aggregate returned -4.69% for the quarter and -10.35% for the first half – the worst six months performance since 1980. In both the early 80’s and today, very high inflation and corresponding tight monetary policy have been the main drivers behind the poor bond market performance. Inflation has yet to show signs of moderating, but investors are already pricing in a reversal of policy rates next year – markets are pricing for the Fed and Bank of Canada target rates to peak around 3.5%, and to fall thereafter.

There was much discussion during the second quarter of rising recession probability on the back of rising consumer prices and interest rates. However, credit markets do not appear to be yet making the same prediction. Yield spreads have widened, particularly for high yield, but not yet to levels that we believe indicate imminent recession. The average US investment grade 3-5 year corporate and overall corporate high yield spreads are now at 130 and 566 bps, respectively, compared to 399 and 1099 bps for the pandemic peaks, and 666 and 1962 for the credit crisis peaks.

Portfolio Activity

Given higher yields and inversion of the 5 to 30- year yield curve, the portfolio’s bias to a flattening yield curve, which proved profitable, was reduced by increasing exposure to the 5-year area of the yield curve and decreasing exposures to both long-term provincial and short-term (<1 year) corporate debt and decreasing excess cash. The portfolio’s relative short-duration, and sector and high credit quality biases were maintained.

What Worked in the Quarter

The portfolio benefitted from having a shorter duration (~1.5 years) relative to the benchmark, given the rise in yields. The inversion of the 5 to 30-year curve also was a positive for performance, given the flattening yield curve bias of the portfolio. Outperformance of Alberta and Saskatchewan debt, on improved budget forecasts, also added to performance given their concentration in the portfolio. The market overweight in credit also provided additional yield for the portfolio.

What Didn’t Work in the Quarter

The conservative positioning of corporate credits along the yield curve, with an overweight in short-term holdings in lieu of long-term holdings, was negative for performance, given bear flattening of the corporate credit spread curve.

Outlook & Strategy

We expect the Fed and the Bank of Canada to follow through on the magnitude of their guidance for policy rate hikes. However, persistent inflation and central bank creditability is clearly putting pressure on central bankers to accelerate their increases. 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 believe that household balance sheets are still in relatively good shape, having benefitted from low borrowing costs and reduced consumption during the pandemic. Additionally, current consumption is being restrained by inadequate supply of goods and services. We expect inflation to eventually slow when demand pressures subside, and do not place much faith on supply-side factors normalising first.

Bond yields have adjusted higher in a hurry; however, we could easily see more volatility if inflation persists, and signs of a slowdown emerge. Unfortunately, the effect of the pandemic and war continue to distort economic data, which makes it difficult 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.

We have maintained a shorter duration in the portfolio in the event that yields continue to be pressured higher and have reduced exposure to more vulnerable credits in the face of higher yields and the potential for significant economic slowdown as rates and prices eventually bite.

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Disclaimer

Asset Management