Short-Term Bond

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 short-term yield curve flattened as overnight rates were increased by 125 basis points, while 5-year yields rose by 58 bps. In Canada, the move of the curve was similar with overnight rates increased by 110 bps and 5-year yields also rising by 59 bps. By quarter-end, the US and Canadian 2 to 5-year yield curves were noticeably inverted, both by 8 bp, 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 Short Term Index returned –1.88% during the quarter to end the first six months of the year at –4.39% – the worst six months period since 1994. 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 short-term government yields and wider credit spreads, exposure to two-year telecom credit was increased, while exposure to one-year provincial debt was decreased, and excess cash reduced. The portfolio positioning for higher yields and steepening credit curve was maintained, with a short relative duration and positions in liquid, higher-rated credits.

What Worked in the Quarter

The portfolio benefitted from having a shorter duration (~0.6 years) relative to the benchmark, given the rise in yields. Demand for short-term high quality liquid assets resulted in short-term provincial spreads tightening by 2 bps, which was positive for performance as the portfolio was overweight provincial credit on both a duration and market value weighted bases. The market overweight in provincial and corporate credit also provided additional yield for the portfolio.

What Didn't Work in the Quarter

Corporate credit came under further pressure in the second quarter as headwinds from persistent inflation and aggressive monetary policy weighed on market sentiment. The overweight of corporate credit was negative for performance, however, the portfolio's corporate holdings experienced less credit spread widening than the market due to sector and issuer composition.

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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Asset Management