Short-Term Bond

July 2022

Market Highlights

Bond Investors decided that the faintest indication of slowing coupled with the Fed's ongoing commitment to rate hikes was enough information to take on duration risk. Consequently, 5-year yields fell by 36 bps to 2.68% over the month, causing the US treasury curve to invert with the 2 to 5-years yield curve now at -28 bps, as 2-year yields fell by only 7 bps. The Canadian 2-5's curve is now at -38 basis points. The rally in the bond market resulted in large monthly gains for both the Bloomberg Short US Aggregate: 1.03% and the FTSE Canada Short-term Bond Index: 1.21%.

Some of the high frequency data did present some weakness: ISM manufacturing data weakened, housing starts, existing and pending home sales all continued their contractions, and consumer confidence and sentiment remained weak. Perhaps most importantly, the JOLT survey appeared to have plateaued with job openings and quits both falling, albeit marginally, alongside the rise of jobless claims.

As of July end, Fed Funds Futures were pricing in policy rates peaking at under 3.3% by year-end; and then falling to just over 2.5% by December 2023. Subsequently, expectations have risen such that Fed Funds will peak at 3.7% in February 2023 and then fall to only 3% by December. (In practice the target for Fed Funds will fall on a quarter point, but future market probabilities can result in expectations mid-way.) The strength of the labour markets, stickier inflation numbers and convincing hawkish comments from the Fed appear to have made investors rethink their expectations for a more imminent reversal of policy. The picture is much the same in Canada, with Overnight Indexed Swaps suggesting a similar path for the Bank of Canada policy rate.

While the July JOLT survey showed a hint of weakness in jobs, the surprisingly strong July Nonfarm payrolls print of 471k plus and upward revision to 404k for the previous month, appear to be the key factors causing investors to question the imminent recession narrative, thus creating more volatility in government yields. Nevertheless, the steep inversion of the 2-10's Treasury curve suggests that for the time being there is a substantial base of investors expecting a material slowdown next year. We think policy rate expectations and longer-term government yields are somewhat out of sync and consequently expect to see continued volatility.

US corporate yield spreads narrowed from their recent widest levels at the end of June, as investors chose to ignore macro concerns in favour of improved financing conditions, healthy corporate credit metrics and a constructive earnings season. Lower sovereign yields as well as relatively wide corporate yield spreads was an additional incentive for investors to search for additional carry in the corporate market.

Outlook & Strategy

We expect the Fed and the Bank of Canada to follow through on the magnitude of their guidance for policy rate hikes. Persistent inflation and central bank creditability has put 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, reduced consumption during the pandemic, and importantly, wage gains. 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 concrete 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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