Focused Fixed Income

August 2022

Market Highlights

Markets were uncharacteristically active during the hottest (pun intended) vacation month, reacting to the hawkish statements from Fed Chairman Powell at the Jackson Hole confab. More broadly, central bankers are keeping to the tightening script with the Bank of Canada, ECB, Fed and Bank of England all hiking rates by large amounts. In North America, yields rose abruptly, as high frequency data (e.g., employment, retail sales and ISM) are not yet convincingly displaying economic danger signals from the combination of higher prices and higher borrowing costs. Although consumer confidence has declined, consumer behaviour – most prominently in the form of service consumption – is not yet confirming sentiment.

The early summer rally in mid and long-term bonds was all but wiped out in August… only the gains from the second half of June remain. Recall that in June, bonds rallied as investors concluded that the signs of declining inflation would cause the Fed to pause from its tightening policies before it reached its FOMC “dot plot” targets. However, the subsequent strength of the job market and persistent inflation, albeit below the peak, have resulted in expectations of additional tightening beyond the median FOMC forecasts. Bond yields have subsequently risen from the recent lows, with the rise being the most acute in the short end – investors are still expecting a significant slowdown that will eventually reverse yields.

Yield curves have continued to flatten. In Canada, the 2 to 10 and 30-years curves are now both just over -50 basis points (the 10-30’s curve is flat), while in the US, the 2-30’s curve is about -10 bps and the 2-10’s curve, about -25 bps. The disproportionate flattening in the US 10-year area appears to be technically driven, with the 10 to 30-year spread reaching 66 bps at the height of the rally at the end of July, only to narrow back to 15 bps as the market has sold off. Bond market volatility has been extreme with Treasury market volatility back to early pandemic levels (ICE BofA Move Index for US Treasuries).

Investment grade yield spreads have moved along with the movement in underlying yields and have thus widened most recently. However, the volatility in IG spreads pales in comparison to what has been seen in the high yield market. Average US HY spreads (Bloomberg) have moved in a nearly 200 bp range since the end of May whereas average US IG spreads (Bloomberg) have moved in a 30 bp range over the same period – both spreads are slightly below the middle of their respective ranges today.

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We expect the Fed and the Bank of Canada to eventually surpass their current 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 soften 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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