



## Short-Term Bond

October 2022

### Market Highlights

Sovereign yields have risen substantially across the globe this year, with the biggest rise amongst developed countries occurring in the US. Five-year and under Canadian and US sovereign yields peaked in October but fell slightly by month-end, albeit well within levels captured by market volatility. The spread between US and Canadian yields widened significantly during the month as investors began to sense a slight divergence in economic fortunes and ultimately policy between the US and Canada.

Volatility continued its assault on bond markets in October as volatility levels almost reached the pandemic highs of March 2020. The widely followed ICE BofA Move Index volatility measure hit 161 on October 12 compared with the short-lived high of 164 on March 9, but much lower than the historical peak of 265 set during the credit crisis. To put this in perspective, the ten-year average (including the recent elevated period) of the index is 70 and was only above 80 for five weeks 2020; this year it has been above 120 for almost six months, and above 140 for the last six weeks.

Bond investors are clearly having difficulty with interpreting the data and in-turn monetary policy. The economic news has not been convincing either way – weak housing and retail sales, but strong labour markets and services demand. More importantly, inflation has remained stubbornly high, which has resulted in central banks falling behind the curve (and inflation), and subsequently having to play catch-up with guidance. For its part, the Bank of Canada has not been a particularly good communicator, surprising the market with only a 50 bp hike in October and signalling a lower trajectory of rate increases. The Fed's shift was more elegant, ratifying the market with a 75 bp November 2 rate increase, while suggesting smaller increases ahead likely resulting in a higher terminal rate than recently projected.

While central banks are well into their tightening cycles – the Bank and the Fed have raised rates by 350 bps and 375 bps, respectively – the increases have been rapid and there is still not enough evidence that tighter policy is making enough of a dent on inflation. Canadian headline and core common CPI are running at 6.9% and 6%, respectively, while in the US headline and core inflation are running at 8.2% and 6.6%, respectively – all well above target.

Risk asset prices have also been volatile, but no where near levels of the bond market when put in an historical context – the VIX (CBOE Volatility Index) has been just above 30, which pales in comparison to the 80-level experienced during the early pandemic and the credit crisis. Corporate credit spreads have been similarly volatile but finished the month close to their peaks this cycle. In Canada, corporate yield spreads finished the month at their cycle highs of 158 for short-term bonds.

### Outlook & Strategy

We believe that investors and central banks will continue to play catchup with monetary policy. Throughout the tightening cycle, the persistence and transformation of inflation has been underestimated. We think that both the Fed and the Bank of Canada will be forced to continue raising rates until inflation is brought back to target – they will not be able to stand to the sidelines early. Although both banks have raised policy rates quickly to increase the speed with which tighter monetary policy will translate through the economy, policy began at very accommodative levels and amidst relatively strong economic fundamentals. It will take time for labour markets to loosen and the threat of rising wages to diminish. We do think that both banks will elect to lower the magnitude of increases, recognizing that they are likely to be forced into lengthier tightening cycles than earlier anticipated, thereby reducing the eventual level of terminal policy rates. Markets expect the Bank of Canada to lag the Fed as the Canadian economy appears more vulnerable to rate increases. However, we would caution that the weakening currency will have an offsetting inflationary impact to slower growth. We expect any increase in yields to appear across yield curves, but also expect that inversion will remain. Further out, an economic slowdown is inevitable and a recession probable. We are still cautious on the bond market and prefer to maintain reduced duration exposure with a bias to yield curve inversion.

Risk assets are still vulnerable to higher interest rates and more importantly a recession. Although bond issuers have taken the last few years to improve their balance sheets, the weakest issuers will be the most vulnerable to an economic slowdown. Although corporate yield spreads have widened this cycle, we believe spreads do not reflect the liquidity contraction that could ultimately take place. We are short duration and have increased the quality of our credit exposure, which we feel continues to be appropriate.



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