



Short-Term Bond

November 2022

Market Highlights

Yields reversed course in November as investors interpreted the data and Fed communication as indicative of a more imminent pivot in policy and reversal of interest rates. At month-end Fed Fund futures contracts were suggesting that policy rates would peak at roughly 5% next summer but fall to 4.5% by year-end, despite Fed Chair Powell's protests that rates would have to remain higher for longer. In Canada, month-end OIS contracts indicated a lower peak of Canadian policy rates, relative to the US, of only 4.25%, also in the summer, with a similar subsequent reduction thereafter. The markets pricing of near-term policy rate increases has not changed materially since the end of October (albeit with intermittent volatility) despite the Fed's more recent protestations that the terminal policy rate would have to be higher (than the September dot plots) and remain so for longer. It appears that markets were already pricing-in this scenario by the end of October.

Bond market volatility has remained at elevated levels (for over six months) more akin to a crisis environment like early pandemic (March 2020) and the Credit Crisis (2008-2009) – see the ICE BofA Move Index. This is despite the fact that US unemployment remains at historically low levels and real US GDP growth is yet to show signs of material weakness – the recent estimate for Q3 was 1.9% yoy. Notably, the Bloomberg Consensus real GDP forecast for 2023 is 0.4% yoy. In Canada, bond market volatility has been much lower with Government of Canada yields not rising as high as US Treasury yields and daily movements more muted. Canadian 2022 real GDP estimates are much higher than for the US at 3.3% yoy, but with 2023 forecasts similarly low at 0.5% yoy.

Economic data has been mixed with some sectors, particularly interest sensitive ones such as housing, indicating significant slowdown. The rotation from goods to services continues to be in evidence with retail sales recently posting negative growth and advance estimates for Black Friday/Cyber Monday sales indicating volume decreases, but with \$ increases. Although services PMI's have also slowed, they are above neutral; manufacturing PMIs are negative. We feel that the supply and demand distortions created by the pandemic are still embedded in the economy and are still contributing to goods and service demand patterns. Although the economy and inflation appear to be slowing, inflation is not falling quickly enough. Employment data continues to be robust with unemployment rates remaining stubbornly low and wage gains disturbingly elevated.

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 close 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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