LORICA

Short-Term Bond

December 2022

Market Highlights

After the relentless backup of bond yields that began in last Q4, we finally got some relief this Q4. Yields continued their rise through October, but the Bank of Canada's pivot to a smaller rate hike following its early December meeting was taken by both Canadian and US investors as a buying signal. Yields subsequently declined until, for what at first seemed like a positive sprint to year-end but what turned out to be, a fade in mid-December and a negative limp to New Years. Short-term Government of Canada yields finished the quarter higher by 55, 26, 13 and 13 basis points for one, two, three and five years, respectively. The FTSE Canada Short-Term Index ended the quarter with a 0.67% return versus 0.10% for the FTSE Canada Universe. The index lost -0.15% in December, reversing the 0.88% November gain. Short-term corporate and provincial bonds fared better, with corporate and provincial yield spreads narrowing from their widest levels at the end of October to finish the quarter an average of 10 and 3 bps tighter, respectively.

During the quarter, the short (one to five-year) US yield curve flattened by 75 basis points, as one-year yields increased by 68 bps and five-year yields decreased by 7 bps. The Canada yield curve flattening was relatively muted at 42 bps, with one-year yields rising by 55 bps and five-year yields rising by 13 bps. The peak of yield curve inversion roughly coincided with the reversal in bond yields. The spread between five and one-year Government of Canada bonds reached a trough of -151 bps, steepening to –120 bps by year-end. As of year-end, the US and Canada short-term curves were inverted by 74 and 119 bps, respectively, reflecting investors expectations of a reversal of monetary policy later this year.

OIS markets in Canada imply that the Bank of Canada will raise rates by slightly more than one (25 bp) hike by April, but will reverse course, shortly thereafter, easing two hikes by the end of 2023. The markets are not consistent with BoC and Fed guidance, which has indicated policy will remain tighter for longer, not yet ready to declare victory over inflation, which has slowed but is still way above target.

Portfolio Activity

Given higher short-term government yields, exposure to three-year provincial debt was increased through the reduction in shorter-term provincial debt and excess cash. 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 (by one year) relative to the benchmark, given the rise in yields. The portfolio was overweight corporate credit, with concentrations in banks, pipelines, telecom and media debt which outperformed. The portfolio had no exposure to issuers in real estate, power generation, securitization and utility which lagged. Similarly, the overweight in provincial credit on both duration and market value weighted bases benefitted performance. The market overweight in provincial and corporate credit also provided additional yield for the portfolio.

What Didn't Work in the Quarter

The portfolio was conservatively structured with concentrations of two to three-year bonds in lieu of four to five-year bonds which was negative for performance, given the bear-flattening (greater rise in short-term yields) of the short-term yield curve.

Outlook & Strategy

We expect investors and central banks to continue to play catchup with monetary policy. Throughout the tightening cycle, the persistence and transformation of inflation has been underestimated. Although, both the Fed and the Bank of Canada have adopted more flexible inflation targeting frameworks, we believe they will both be forced to continue raising rates until inflation is brought back close to target. While commodity and goods prices are moderating, there is still significant pressure on services. The strength of consumer demand, coupled with labour market tightness and real wage losses will likely mean further wage gains lie ahead. This will force central banks to continue to tighten policy until demand softens by slowing wage gains. But this will take time. Both banks will continue with smaller increases to reduce the eventual level of terminal policy rates, recognizing that they are likely to be forced into lengthier tightening cycles than earlier anticipated.

Overall corporate yields have risen significantly over the last year and offer attractive risk/reward opportunities. The significant inversion of the yield curve, the relative flat corporate yield spread curve, and low duration risk, make short-term corporates look particularly attractive. We are comfortable with the investment grade credits, recognising that spread volatility could still play havoc with lower rated issues, particularly in the event of a significant slowdown.

We believe that an economic slowdown is inevitable further out, 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. We expect any increase in yields to appear across yield curves, but also expect that inversion will remain.

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Cidel Asset Management