# Focused Fixed Income

January 2023

## Market Highlights

The Canadian and US bond markets both returned 3% for January according to the FTSE Russell Canadian Universe and Bloomberg US Aggregate indices, respectively. The weak ISM and average hourly earnings data early in the month initiated the rally which was fuelled by weak inflation data. The Bank of Canada ratified investor optimism (both in the US and Canada) by raising policy rates by an expected 25 basis points, and more importantly, signalling a move to the sidelines for further tightening, unless inflation proves them premature. While bond market volatility has not disappeared, the direction for yields and yield spreads was undeniably down in January – two and ten-year yields declined by 30 and 38 basis points, respectively. Notably the first week in February, following an expectedly robust US payrolls report, has forced a dramatic rebound across the yield curve equivalent to about half of the January move.

The slope of the US and Canadian yield curves, which reached their maximum inversions in early December and steepened into year-end, did not change much during January. The market is still pricing in lower policy rates in the back half of the year, expecting the target Fed Funds to be lowered by 25 bps by year end, from a peak of 5.25% in the summer. Though the Fed has made it clear that the most likely scenario for policy is no easing in 2023, investors do not appear to be paying much attention. At the FOMC meeting on February 1, Chair Powell, did emphasize the Fed's statement that there would likely be more hikes this year, but the market preferred to focus on the Fed's observation that inflation is coming down quickly, rallying yields across the curve before the post payroll sell-off.

Investors continued to embrace corporate bonds in January, moving yield spreads in by an average of 12 bps in Canada despite $11.3B of new issues in January, surpassing the 5-year average January issuance of $9.4B. US investment grade and high yields spreads moved in by an average of 13 bps and 48 bps, respectively, highlighting investor confidence in risk assets. In general, corporate yield spreads imply investor optimism for a soft landing this year, perhaps slightly out of synch with the government market, with the steep inversion suggesting a harder landing.

## Outlook & Strategy

We expect investors 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. 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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