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Focused Fixed Income

March 2023

Market Highlights

March capped off one of the most volatile quarters of the last fifty years. Yields moved up and down as investors grappled with the news and central bank messaging. The Bloomberg US Aggregate Index returned 3.08%, -2.59% and 2.54% for January, February and March, while the FTSE Canada Universe Index returned 3.09%, -1.99%, and 2.16% for the same periods. In response to the collapse of SVB bank on March 13th, we saw the largest one day drops for 2-year Treasury yields since the Volcker years at -61 basis points; Government of Canada's yields fell by 42 bps. The front of the yield curve was particularly volatile as investors continued to vacillate between Fed tightening and easing. During the quarter 2-year Treasury yields traded in a 130 bp range versus 30-years which traded in a 45 bp range. Government of Canada's short-term yields were less volatile with 2-years trading in only a 90 bp range as the BoC was more deliberate and dovish, taking itself out of play following the mmm meeting. Thirty-year bonds tracked similar term treasuries.

The economic data during the quarter was mixed, but enough of a downward movement to allow the Fed and the BoC to downshift their tightening plans. US employment showed some softening, although unemployment remained near historical lows. Inflation pressures subsided, benefitting from the decline of energy prices, albeit still well-above target. And Q1 US growth, despite surprising to the upside, was weaker than Q4. Canadian employment showed unexpected resilience during the quarter (Canadian payrolls are notoriously volatile), particularly with January's upside surprise of 150k new jobs. Inflation pressures declined below expectations.

The collapse of SVB, Signature and Credit Suisse banks, were the big event of the quarter. Higher yields finally revealed kinks in the financial system with certain regional banks showing particular vulnerability given large and concentrated commercial deposits and (duration) mismatched investments. SVB's collapse was akin to a classic bank-run with depositors heading for the exit all-at-once, accelerated by today's rapid transmission of information and facilitated by access to online banking. The Fed stepped in quickly, guaranteeing deposits and providing additional liquidity to banks through a Bank Term Funding facility – drawing on techniques developed during the Great Financial Crisis.

Portfolio Activity

Given inversion of the yield curve and attractive relative value, exposure to short-term (<2 year) senior bank debt was increased through a reduction of longer-term (~3 year) provincial debt and the use of excess cash.

The portfolio's short duration, flattening yield curve, sector and high credit quality biases were maintained.

What Worked in the Quarter

The portfolio was positioned for yield curve flattening with an overweight in short and long-term debt in lieu of mid-term (7-10 year) debt – the 5-30 yield curve flattened by 12 bps during the quarter.

Performance benefited from industry and issuer composition, including being overweight outperforming short-term telecom, media, pipelines, and senior bank debt, which resulted in greater credit yield spread performance than the market. The portfolio was underweight industries (oil and gas, real estate, power generation and subordinated bank debt) which underperformed. overweight of outperforming short-term telecom, media, pipelines, and senior bank debt. The portfolio was underweight underperforming oil and gas, real estate, power generation and subordinated bank debt.

The market overweight in provincial and corporate credits provided additional yield for the portfolio.

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What Didn't Work in the Quarter

The portfolio was conservatively structured with a duration of just over 5 years, approximately 2 years shorter than the benchmark, which was negative for relative performance given the decline in yields.

The portfolio was overweight long-term provincial in lieu of mid-term provincials which was negative for performance given the 6 bps steepening of the provincial yield spread curve.

Outlook & Strategy

The decline of energy prices and easier year-over-year comparisons has helped the decline of inflation rates. But China's coming fully on-stream and OPEC activities will likely alter the commodity price dynamic. In addition, the persistent low levels of unemployment coupled with the rotation of consumption away from goods, should support demand for services. Although wage growth has moderated, we expect tight labour markets and the decline of real wages to keep pressure on overall wage growth.

We believe that we are likely close to the end of interest rate increases, but don't necessarily concur with market expectations for a dramatic reversal of policy rates this year. Throughout the tightening cycle, investors and policy makers have underestimated monetary tightening. We expect the Fed will go once more this year, but then will remain on hold. The Bank of Canada is likely to remain on hold but could get pushed back into action if growth and inflation surprise. Despite, both the Fed and the Bank of Canada having adopted more flexible inflation targeting frameworks, we believe both will be reluctant to reverse policy until inflation is brought back close to target.

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.

The short end of the bond market has been particularly volatile. Investors are now pricing in significant policy reversal in the second half of this year. The curve between the Bank of Canada Overnight Rate and Government of Canada 2-year bonds is steeply inverted, with the rest of the curve less so. We think that this is an area of the curve that is particularly vulnerable to some steepening but expect the overall inversion of the yield curve to remain.

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