



Focused Fixed Income

May 2023

Market Highlights

In May, the Canadian bond market returned -1.69%, giving back 40% of the year's return to April (4.23%) according to the FTSE Canadian Universe Index. The US bond market outperformed at -1.09%, only losing 30% of its year's return according to the Bloomberg US Aggregate Index. Stronger-than-expected economic data forced investors to reconsider expectations for inflation, growth, and ultimately central bank action, driving yields upwards across US and Canadian yield curves. In the case of the Federal Reserve, investors have been led to believe that the Fed would follow a data dependent course, and with the data surprising on the upside, investors reacted adversely. The Bank of Canada has provided more guidance than the Fed, electing to suggest a more passive stance; however persistent strong data has prompted investors to question the Bank's commitment to remaining on the sidelines.

Although the US debt ceiling drama proved to be a non-event, it did contribute to the volatility that has besieged the bond market since the tightening cycle began. In May, Canadian yields traded within as much as an 80 basis point range in the short-end and 40 bps in the long-end. For the month, Canadian yields uncharacteristically rose more than US yields with Government of Canada and US Treasury 2, 5, 10 and 30-year yields higher by 56/40, 47/27, 35/22 and 21/19 bps, respectively. Notably, Canada OIS and Fed Fund markets are now pricing in 44% and 24% probabilities of rate increases by the BoC and Fed at their respective June meetings. The rest of the US and Canadian policy forward rate curves are predicting easing early in 2024.

The regional banking problems – we are reluctant to call it a crisis, in hindsight – were evident again heading into May as First Republic Bank became the next official bank casualty with its seizure by the FDIC and majority sale to JP Morgan. US corporate yield spreads widened in response to the failure (which was not a surprise) but finished the month almost unchanged. Spreads are close to the recent lows established in April but are still about 10% higher than the “pre-banking problems” lows of February. Canadian corporate spreads did not react to the events in May, but Canadian corporate yields spreads, are similarly still about 10% higher than the February levels.

Outlook & Strategy

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. Although the Fed has indicated the potential for pausing, we are not yet ready to declare an end to its tightening cycle, and we do not expect any easing this year. The Bank of Canada is likely to remain on hold but could get pushed back into action. 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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