What We Think…

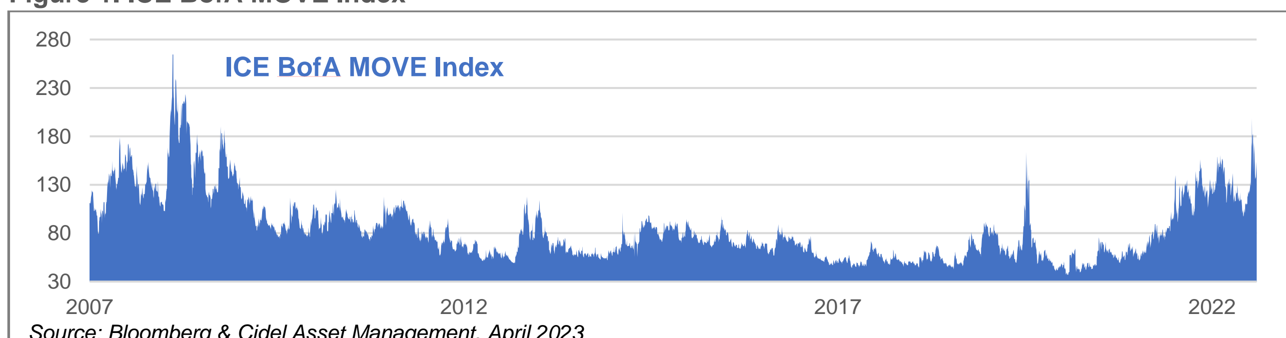
March 2023

VOLATILITY

Volatility has been the constant state of the bond market for just over a year now, ever since it became apparent that central banks would aggressively be raising interest rates. Government bond yields have been the most volatile since the Global Financial Crisis (GFC), in some ways even more so. (See Figures 1 & 2.) Two-year Treasury yields experienced the greatest one-day yield change since the early 1980's – twenty basis points more than the largest change during the GFC. We had thought that we had seen the worst of the volatility in 2020, only to see it eclipsed in March as investors responded to fears concerning the banking sector that resulted in violent bond price swings.

Since Central banks have been raising rates, investors have been torn between concerns over inflation on one hand and the effects of tighter monetary policy on the other. Many have expected to see an imminent economic slowdown resulting from the cumulative and rapid policy rate increases, while others have focused on the stronger-than-anticipated labour markets. In terms of guiding the bond market, the Fed has been somewhat absent this cycle, leaving investors to mostly fend for themselves – the results have not been pretty. After lowering rates dramatically at the onset of the Pandemic, the Fed committed to staying on the sidelines despite the persistent increase of inflation. Later, it reacted aggressively albeit belatedly, attempting to appear sure footed that its abrupt policy response was necessary and part of a plan. In January, the Fed exited its aggressive posture, opting for smaller rate increases and once again highlighting data dependency. The Fed's messaging has mostly confused investors and its tightening stance has required continual reassurance. Unfortunately, the banking crisis of the last month, has only made it more difficult for the Fed to appear anchored and consistent.

Figure 1. ICE BofA MOVE Index



Source: Bloomberg & Cidel Asset Management, April 2023

Figure 2. Periods of Extreme 1-Day Treasury Yield Movement

Term	The Volcker Years (Nov-79 to Nov-82)			The Great Financial Crisis (Nov-07 to Nov-08)			Last Year (Mar-22 to Mar-23)		
	High	Low	Std. Dev	High	Low	Std. Dev	High	Low	Std. Dev
2	1.46	-1.18	0.23	0.47	-0.50	0.12	0.29	-0.61	0.10
5	0.72	-1.08	0.19	0.41	-0.42	0.11	0.22	-0.30	0.10
10	0.65	-0.67	0.16	0.27	-0.33	0.09	0.24	-0.28	0.08
30	0.50	-0.56	0.15	0.20	-0.29	0.07	0.16	-0.22	0.07

Source: Bloomberg & Cidel Asset Management, April 2023

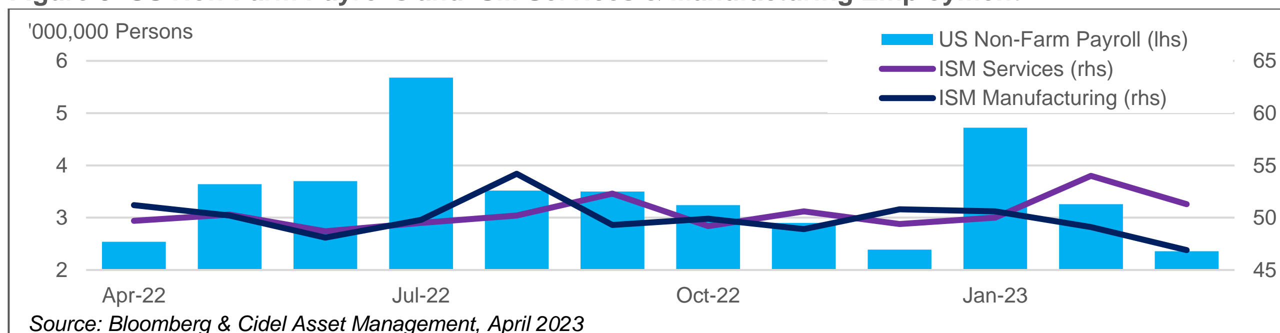
The volatility in the bond market has been amplified by a continual decline of liquidity which has had a troubling impact on the treasury market. Consider: i. Market intermediaries (i.e., the banks) have much reduced liquidity on their balance sheets to help cushion market flows, due to increased regulatory capital requirements. ii. The Feds large balance sheet of treasury and other agency assets has reduced the float of

the most liquid securities in the US dollar bond market. iii. The increasingly large asset sizes of pension, trust, mutual and other funds do not provide the same liquidity as the banks or broker dealers of the past. iv. Algorithmic trading has grown enormously, generating large momentum trades on the back of news flow.

THE ECONOMY

The strength of the underlying economic data has been surprising. Yet, the yield curve has been inverted for nine months – four of them with a 2-30 curve beyond -50 bps, suggesting that the majority of investors are still anticipating an imminent slowdown. The consensus GDP and employment forecast is for deterioration in the second half of the year, with improvement of GDP a year later. Nevertheless, the labour market has proven resilient despite the raft of high-profile layoffs at tech firms and banks. The unemployment rate remains at historical lows, although the most recent data shows some signs of slowing. (See Figure 3.) GDP, while volatile was surprisingly strong in Q4, and will likely be positive in Q1, albeit slower.

Figure 3. US Non-Farm Payrolls and ISM Services & Manufacturing Employment



Source: Bloomberg & Cidel Asset Management, April 2023

For those waiting for the economy or the financial system to crack on the back of interest rate increases, the banking crisis was perhaps the first real sign. Although the housing market has slowed noticeably on the back of higher mortgage rates, green shoots have appeared more recently. And the slowdown in manufacturing has been more difficult to decipher, given the uneven demand created by the pandemic. However, investors were quick to assess the vulnerability of the economy to the banking sector, forcing two-year government yields to fall by over 60 basis points and inversion of the Fed Fund futures curve by more than 100 bps over the next year. Recession probabilities clearly have risen as investors have extrapolated the banking crisis into recession. Many believe that the cracks that have appeared amongst regional banks, are indicative of broader instability in the financial system. Furthermore, they believe that depressed bank share prices and wider bank debt yield spreads will lead to tighter financial conditions.

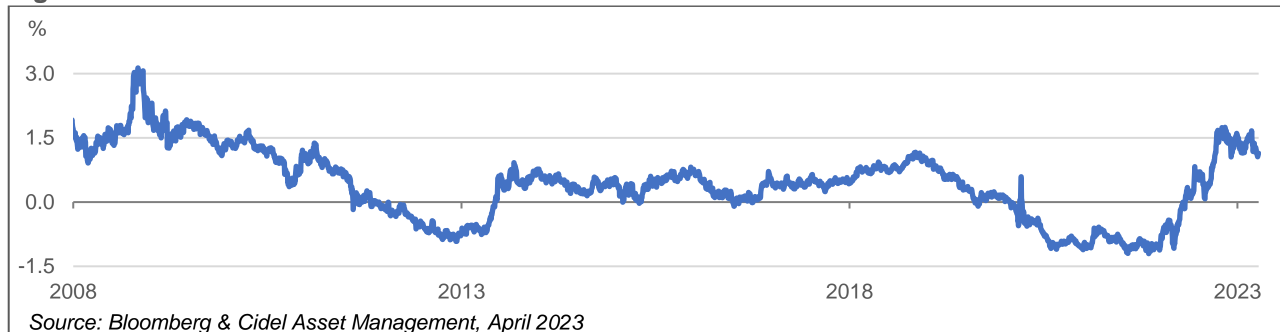
FINANCIAL CONDITIONS

The question as to how tight financial conditions is a difficult one. Fed Funds have risen by nearly 5% from the Pandemic lows and are just over 3% higher than where they were pre-Pandemic. However, bond yields are now substantially off their peaks, and longer-term yields have not risen nearly as much as policy rates. US 2 and 5-year Treasury yields are about 2% and 1.5%, respectively, above where they were pre-Pandemic and only about 75 and 25 bps above where they were at the last tightening cycle peaks. Long-term Treasury yields are about 75 bps above the average of the last 20 years – a lengthy period of low long-term yields. Recall the economic environment pre-Pandemic – the Fed had capitulated abruptly from its (2015-18) tightening cycle when the equity markets began to hiccup. We did not think monetary policy was particularly tight at the time, but inflation was slightly below target despite low unemployment, and the Fed chose to provide further support for risk assets by rapidly lowering rates.

Since Fed tightening began last year, 10-year real yields reached 1.75% – the highest levels since the GFC. They are now closer to 1% – about the same level they were at the end of 2018 (just before the Fed began easing). (See Figure 4.) Prior to the Pandemic, the Fed had lowered the Funds target rate to 1.75%, to be followed by the 150 bp drop early in the Pandemic. During the easing period, prior to the Pandemic, real yields fell below zero – inflation was not a concern, and the Fed was content to test the limits of low unemployment. During the Pandemic, real 10-year yields ultimately fell below -1%, as the Fed tried to

provide liquidity. We believe, that real yields are now restrictive, especially in the context of the last fifteen years. (Interestingly, looking at Real Fed Funds, we don't see indication of the same tightening due to the discrepancy between current inflation and moderate inflation expectations.)

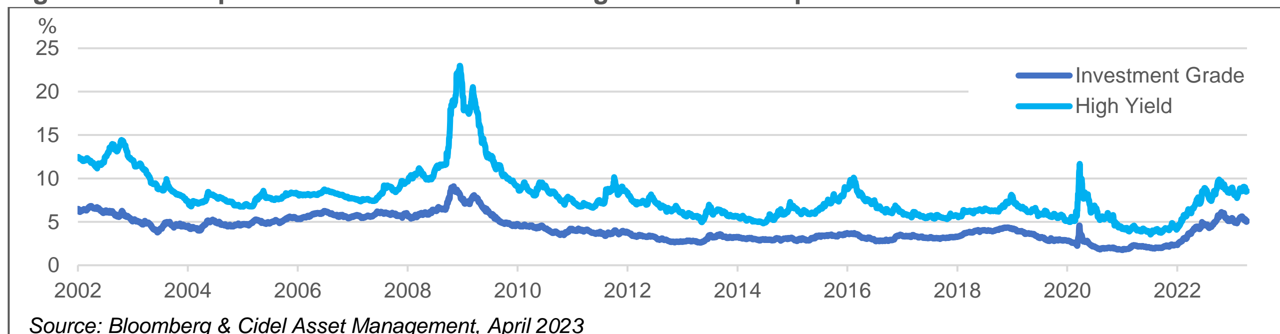
Figure 4. US 10 Year Real Yields



Source: Bloomberg & Cidel Asset Management, April 2023

Corporate yield spreads are another indicator of financial conditions and despite significant inversion of the yield curve several months ago (which many have interpreted as a signal of recession) investment grade (IG) yield spreads have been relatively well contained. More surprisingly, high yield (HY) spreads have remained below the tightening cycle wide's seen last June (and well below the early Pandemic extremes), despite the uncertainty created by last month's banking crisis. However, IG yields (which are a better indication of financing costs) have risen to levels last seen during the latter half of 2009 following the Great Financial Crisis (GFC). One may recall that, at the time, the economy had just come through a recession and corporate yield spreads had finally narrowed from elevated levels during the crisis. With the exception of a few minor episodes over the last fifteen years, 2020 was the only period where we saw panic in investment grade yield spreads since the GFC. High yield spreads, in contrast, have had notable episodes of extreme widening including 2011 (high unemployment and weak jobs growth), 2016 (weak GDP growth) and 2020 (early Pandemic). Although, corporate yield spreads are not particularly restrictive, in the context of the GFC, we believe all-in corporate yields are. (See Figure 5.)

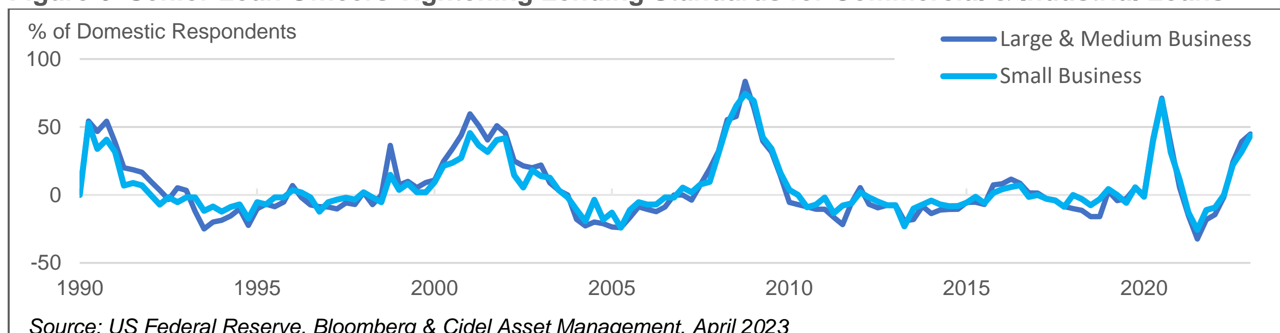
Figure 5. US Corporate Investment Grade & High-Yield Yield Spread



Source: Bloomberg & Cidel Asset Management, April 2023

It is difficult to forecast how significantly the recent banking crisis will impact financial conditions. The problem in the US has been largely with the regional banks and the Fed appears to have contained the damage. While corporate America does not rely heavily on the banking system for financing – where there is significant disintermediation – that is not true for smaller businesses. Many small and mid-size businesses rely on lines of credit and explicit small business loans. Higher yields will have already had some impact on the ability of financial institutions to extend credit, questions surrounding bank liquidity and balance sheet mismatches, will likely impact that ability further. The most recent Fed survey of senior loan officers suggests tighter lending standards are ahead. On the consumer side, banks have been tightening policy through higher mortgage rates and loan-to-value ratios. The goal of Fed policy has been to slow inflation, via reducing the pressure on wages, without totally derailing the economy; reducing capacity of the banking system is an obvious side-effect, and not entirely predictable (a banking crisis not so much). (See Figure 6.)

Figure 6. Senior Loan Officers Tightening Lending Standards for Commercial & Industrial Loans

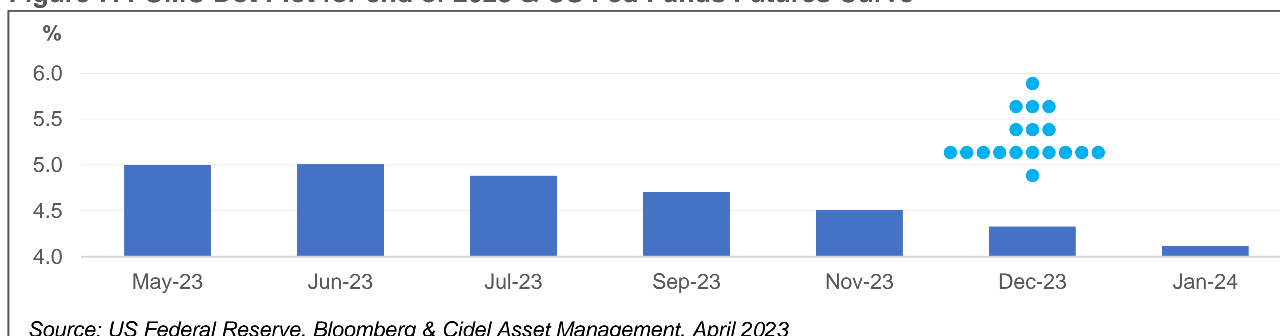


Source: US Federal Reserve, Bloomberg & Cidel Asset Management, April 2023

MONETARY POLICY

Given the tightening of financial conditions that has taken place either explicitly through monetary policy (interest rate increases and quantitative tightening) or presumed through the reduced balance sheet flexibility in the banking sector, markets are now expecting economic weakness will induce policy reversal in the second half of the year. Fed Fund Futures (FFF) are now pricing in a 70% probability that the Fed will raise rates one more time this cycle, followed by subsequent reversal of any increase and an additional 50 bps by year end. But the track record of the FFF contract predicting Fed Funds during the recent tightening cycle has been poor, with the series continually underestimating the amount of tightening that the Fed would deliver to slow inflation. The current FFF curve is also out of sync with the Fed Dot Plots for the Fund Funds Target Rate which does not assume easing this year. The Dot Plots are not that helpful either, given their recent track record anticipating Fed policy. (See Figure 7.)

Figure 7. FOMC Dot Plot for end of 2023 & US Fed Funds Futures Curve



Source: US Federal Reserve, Bloomberg & Cidel Asset Management, April 2023

Many of the questions surrounding monetary policy over the last year remain unanswered. Specifically, how far ahead of inflation actually falling to within the policy target band (1-3%) will the Fed be willing to get, given the risks of being premature. We still don't believe the Fed has regained credibility (from their transitory inflation posturing), and if anything, their guidance has been underwhelming and has resulted in the market overreacting to real-time information. The Fed's response to the recent banking crisis was competent (relying on Great Financial Crisis experience), but the apparent shortcomings in bank oversight that contributed to the crisis has only given more ammunition to critics. We think the Fed will prefer to be cautious unless the combination of an impending recession and falling inflation becomes obvious. For 2023, we think that the FF Dot Plots are more likely to be right than the FF Futures.

The Bank of Canada is presumed to be on hold given its fairly explicit guidance following its January 23 meeting. The overnight indexed swap (OIS) market is also predicting a decline of policy rates by 25 bps by year end, beginning in Q3. However, the Canadian economy continues to outperform the BoC's growth expectations, and the job market remains strong. Inflation has been trending down, and we may see some additional favourable prints given easy comparisons from a year ago (e.g., high energy prices), but services and food have not yet eased sufficiently to give the bank real respite. It will be interesting to watch BoC guidance for policy, but we ultimately expect that the OIS market will eventually revalue expectations policy rates for the end of 2023 upwards.