Focused Fixed Income

September 2023

Market Highlights

A very tough quarter for bond markets despite yields that began the quarter mostly over 4% across the yield curve – the average yield-to-maturity of the FTSE Canada Universe Bond Index was 4.37% on June 30th and rose to 4.97% by September 29th. The Universe Index returned -3.87% for the quarter and is down 1.46% YTD. The long end of the yield curve was particularly hard hit, with 30-year Government of Canada's losing 13.5% for the quarter, -8.31% of that during September. The only worse performing Canadian bonds during the quarter were real return bonds, with 30-year RRB's losing 14.5% caused by the backup of real yields. Year-to-date 30-year RRB's have lost 18.6% versus 8.5% for nominal bonds. Corporate credit fared much better than governments during the quarter, given spread narrowing and the additional yield pickup – e.g., mid-term corporates returned -2.56% versus -3.63% and -4.36% for similar term provincials and Canada's.

The bond market backup was driven by bear steepening of sovereign yield curves (rise in yields increasing with term) – 69 basis points of 2 to 30-year steepening in the US versus 43 bps in Canada. Yield curves have been stubbornly inverted despite the Fed's enduring protestations that yields will have to be higher for longer. The rising probability of a soft landing, the prospects for higher government debt issuance, and the continuing pain of more term risk for less yield, has ultimately proven too costly for investors, thus resulting in dis-inversion of yield curves. Canada's yield curve is still materially inverted (106 bps 2-30's), indicative of the economic struggles facing Canada. Despite Canadian core inflation still a concern at around 3.5%, Canadian real GDP growth appears to have stalled, and is doing worse on a per capita basis.

Portfolio Activity

Given our rate and yield curve forecasts, and attractive relative value, late in the quarter, five-year provincial and senior bank debt were purchased from the proceeds of provincial and corporate maturities. Exposure to short-term diversified financial debt was also increased with a commensurate reduction in short-term telecom debt which had outperformed.

The portfolio's short relative duration was reduced from -2.5 to -2 years towards the end of the quarter, while the yield curve, sector and high credit quality biases were maintained.

What Worked in the Quarter

The portfolio was conservatively structured with an average duration of 5 years, almost 2· years shorter than the benchmark, which was positive for relative performance given the significant rise in yields.

Corporate exposure was neutral on a duration weighted basis, however performance benefited from industry and issuer composition, including an overweight in outperforming short-term insurance, information services and senior bank debt. The portfolio was underweight underperforming industries including real estate, utilities, securitization.

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

What Didn't Work in the Quarter

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Outlook & Strategy

Markets are now pricing in the probability of unchanged policy rates over the next twelve months in both Canada and the US. Investors seem to believe that central banks have delivered enough policy tightening to slow inflation further and will be content to watch it happen. The risk of course, is that central banks will have to tighten more – they have been behind the curve this whole tightening cycle – and economies will ultimately get pushed into recession. We think the Fed has room to manoeuvre before forcing a recession, the Canadian economy is already dangerously close affording the Bank of Canada less wiggle room.

US long bond yields have adjusted higher as we thought they may, Canadian long bond yields, not so much – and they may not get there. The chronic supply/demand imbalance in Canada's long end, generally means a shallower yield curve in Canada. More importantly, the Canadian economy with its narrower industrial makeup, perpetual low productivity, and high household leverage is more vulnerable to higher interest rates, so the inverted yield curve may in fact portend very slow growth, if not recession.

We have been positioned for higher yields and a steeper yield curve, and more defensively on credit. We will look for opportunities to increase duration and reduce the steepening curve bias, while maintaining relatively high running yield. We will maintain the defensive credit positioning, with good liquidity to capitalize on relative value and yield enhancement opportunities.

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