Short-Term Bond

September 2023

Market Highlights

A very tough quarter for bond market returns despite yields that began the quarter mostly over 4% across the yield curve – the average yield-to-maturity of the FTSE Canada Short Term Bond Index was 4.77% on June 30th and rose to 5.17% by September 29th. The Short-Term Index returned -0.12% compared to -3.87% for the Universe Index for the quarter and is up 0.88% 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. By comparison, 2-year Canada's were up 0.35% for the quarter and up 0.96% year-to-date. Corporate credit faired much better than governments during the quarter, given spread narrowing and reasonable pickup – i.e., short-term corporates returned 0.13% versus -0.41% and –0.08% 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. The short term (1-5 year) yield curve flattening at 28 bps was most of the overall yield curve move in Canada, where it was about half in the US at 31 bps. 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 debt was purchased from the proceeds of provincial maturities and excess cash.

The portfolio's relative duration underweight was reduced by ⅓ of a year to 1⅓ year, while maintaining the yield curve, sector and high credit quality biases.

What Worked in the Quarter

The portfolio was conservatively structured with an average duration of approximately 1 1/3 year, well below the benchmark duration, which was positive for performance given the significant rise in yields.

The portfolio was positioned for and benefitted from yield curve steepening, given the significant overweight in short-term (<2 years) debt.

Performance also benefited from industry and issuer composition, including overweights in outperforming short-term insurance, information services, senior bank and financial services debt. The portfolio was underweight industries real estate, utilities and securitization debt which underperformed.

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

What Didn't Work in the Quarter

Short-term provincial yield spreads widened by an average of 2 bps, which was negative for performance given the overweight of provincials on a duration weighted basis. However, the provincial underperformance was partially offset by the overweight of Alberta credit which was a top performer on the back of higher energy prices, rating agency upgrades and reduced issuance expectations given projected budget surpluses.

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 able and content to watch it happen. The risk of course, is that central banks will 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 BoC 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 in balance 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 but maintain our corporate positioning.

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