Focused Fixed Income

June 2023

Market Highlights

The Canadian bond market returned -0.69% for Q2 (according to the FTSE Canada Universe Bond Index) despite yielding 3.95% as at the end of March; the US market returned -0.84% (according to the Bloomberg US Aggregate Bond Index). Yields were volatile during the quarter, but trended higher, as the Fed and Bank of Canada were unable to stay on the sidelines, forced to deal with persistent inflation and scant evidence of materially slowing economies. The poorest performing area of the yield curve was the mid-term area as the yield curve has gradually had to reflect the reality that policy rates will not reverse so quickly, if at all. Yields out to ten years had a significant backup such that overall short, mid and long returns were -0.80%, -1.93% and 0.64% respectively. Notably, 10-year and longer Canada yields are lower than where they began the year, still pricing in the likelihood of a recession sometime in the future.

Although the inverted yield curve continues to suggest the likelihood of a recession, and despite May's mini banking crisis, corporate investors remained comfortable with their positions. Yield spreads did encounter volatility during the quarter, particularly in the US during May, but resumed their late winter spread narrowing in June, making corporates the best performing sector for the quarter – e.g., mid-term corporates returned -0.84% versus -1.84% and -2.54% for mid-term provincials and Government of Canada's. Yield spreads are now just above February's cycle lows, back when investors were beginning to believe that the Fed would take its foot of the brake before tipping the economy into recession.

Portfolio Activity

Given the significant inversion of the yield curve, our forecast for the yield curve to steepen (higher yields of long bonds relative to short bonds) and attractive relative value, coupon payments were reinvested into short-term provincial debt.

The duration, yield curve, sector and high credit quality biases of the portfolio were maintained.

What Worked in the Quarter

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

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 2-30 yield curve flattened by 76 bps during the quarter.

The portfolio was overweight long-term provincials which outperformed on reduced issuance, improved fiscal forecasts and positive rating agency outlook changes; and underweight short-term provincials which underperformed given the bull flattening of the provincial yield spread curve (tighter long-term versus short term yield spreads).

Industry and issuer composition was also a positive, given an overweight in outperforming issues of telecom, insurance, pipeline and senior bank debt.

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

What Didn't Work in the Quarter

The were no material duration, yield curve, sector or issue factors that resulted in relative underperformance.

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Outlook & Strategy

We believe that we are closer to the end of interest rate increases but believe central banks will not likely end tightening, let alone reverse policy rates, until core inflation is brought back to target. Both the Fed and the Bank of Canada have reluctantly been forced to continue tightening, despite having indicated their preferences not to. Throughout the tightening cycle, investors and policy makers have underestimated monetary tightening, highlighting the challenges of forward guidance and its effect on market volatility. We expect volatility to continue until policymakers are more convincingly on hold.

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 investment grade credits, recognising that spread volatility could still play havoc with lower rated issues, particularly in the event of a significant slowdown.

The Canadian yield curve is steeply inverted, especially in comparison to the US yield curve, and though we expect the inversion to remain, we think there is room for the Canadian yield curve to "steepen" (higher yields of long bonds relative to short bonds). The portfolio is positioned to take advantage of higher short-term yields and underperformance of the long end of the yield curve.

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