Short-Term Bond

June 2023

Market Highlights

Canadian bond market returns for Q2 were -0.80% (according to the FTSE Canada Short Term Bond Index) despite yielding 4.09% as at the end of March; the US market returned –0.61% (according to the Bloomberg US Aggregate 1-5 Year 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 short-term yield curve continued to flatten, but yields rose across the curve reflecting the reality that policy rates will not reverse so quickly, if at all. Two, three and five-year Government of Canada yields rose by 85, 71 and 67 basis points, respectively. Notably, 10-year and longer Canada yields are lower than where they began the year, presumably pricing in the likelihood of a recession sometime in the future.

Although the 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 – i.e., short-term corporates returned -0.13% versus –0.48% and –0.41% for short-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 likely take its foot of the brakes before tipping the economy into a recession.

Portfolio Activity

Given the significant inversion of the yield curve, our forecast for yield curve steepening (higher yields of longer-term bonds relative to shorter-term bonds) and attractive relative value, coupon payments were reinvested in under 2-year provincial debt.

The short duration, steepening yield curve and high credit quality bias of the portfolio were maintained.

What Worked in the Quarter

The portfolio was conservatively structured with a duration of 1.4 years, approximately 1.3 years shorter than the benchmark, which was positive for relative performance given the 68 bps increase in short-term yields.

The portfolio was neutral provincial and corporate credit in terms of exposure to yield spread changes (duration). However, performance benefited from industry and issuer composition, including an overweight in 1-3 year senior bank, pipelines, insurance and information services debt. The market overweight in provincial and corporate credit provided additional yield for the portfolio.

What Didn't Work in the Quarter

There were no significant negative contributors to performance over the quarter.

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.

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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 longer maturities.

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