Focused Fixed Income

December 2023

Market Highlights

As dramatic as the rise in bond yields was during Q3, the fall in Q4 was even more so. Global bond markets saw a significant repricing of yield curves in November and December following the Fed's policy pivot away from monetary tightening. Ten-year US and Canadian yields declined by 69 and 91 basis points, respectively during the quarter – an abrupt reversal, especially given the much more gradual move upwards – and are now flat and down 19 bps, respectively year-to-date. In Europe, where the rise in yields during 2022 was greater, the reversal in the second half of 2023 was even more extreme, such that the year-to-date 10-year yield declines have ranged from 13 bps in the UK, to around 55 bps in Germany and France, to 151 bps in Greece. Much of the optimism surrounding the bond market can also be traced to headline inflation's decline which is now 3.1% in the US and Canada and an even more friendly 2.4% in Europe. Notably, core inflation is still running above target at 3.1%, 3.5% and 3.6% for the same regions.

US economic data surprised to the upside during the year, supported by a job market which has been slow to weaken. But yield curves are now steeply inverted, which on their own would typically suggest recession – the US and Canadian overnight to 10-year yield curves were -160 and -190 bps, respectively at year-end. But credit and equity markets have been contrastingly buoyant – creating a rising tide across asset classes that most interpret as an endorsement for a soft landing. For his part, Fed Chairman Powell has tried to maintain a stiff upper "policy" lip, supported by dot plots that imply less easing than priced into the markets and corresponding comments that suggest delayed action until H2. But investors are not convinced – Powell did not outrightly dismiss a first quarter ease at the latest post FOMC meeting presser.

By year-end, Fed Funds are expected to fall from 5.25% to 4% according to Fed Fund Futures and the Bank of Canada Policy Rate from 5% to about 3.75% according to Canada Overnight Indexed Swaps – both massive policy moves. But Recall, that at the beginning of 2023, investors similarly had the Fed Funds target rate declining to 4.5% and the Bank of Canada policy rate to 3.5% by year-end. Markets have been poor at predicting the path of monetary policy this tightening cycle, which has resulted in the extreme volatility seen in the bond market. (We believe that Fed transparency, along with reduced market liquidity, has actually increased volatility rather than reduce it.) According to the ICE BofA Move Index (which tracks US bond market volatility through OTC options on US interest rate swaps), volatility over the last two years has averaged about two standard deviations of the average volatility since the credit crisis (2009).

Portfolio Activity

Given our rate and yield curve forecasts, and attractive relative value, ten-year provincial and diversified financial debt were purchased with the proceeds from coupon payments and a reduction to short-term provincial, telecom and senior bank-debt which had outperformed.

The portfolio's short relative duration was reduced from 2.25 years to 1.5 years and the steepening bias increased. Sector and credit quality biases were maintained.

What Worked in the Quarter

The portfolio benefitted from yield curve steepening given an overweight in short-term debt (< 5-year). The 5 to 30-year yield curve steepened by 30 bps over the quarter.

The portfolio was overweight provincials which experienced an average of 7 bps of credit yield spread narrowing following reduced domestic issuance (given strong foreign demand) and credit rating upgrades (Alberta).

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The portfolio was marginally underweight corporate credit (1/4 year) on a duration weighted basis, which was more than offset by industry and issuer composition, including overweights in insurance, telecom, pipeline, and senior bank debt which resulted in greater credit yield spread performance than the market.

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

What Didn't Work in the Quarter

The portfolio was conservatively structured with an average duration of two and one-quarter year shorter than the benchmark, which was negative for relative performance given the significant decline in yields.

Outlook & Strategy

We don't believe the Q4 rally signals the end of market volatility. Rather, we believe that government yield curves and credit markets, as currently priced, are incompatible and both will likely need to adjust. The amount of easing priced into the US and Canadian yield curves implies deflation or recession or both by early next year, while credit markets are priced for much lower policy rates and a soft landing. Although economic growth has slowed in the US and, more visibly, in Canada, we believe it is far too early to conclude that core inflation will decline sufficiently to provide cover for much lower policy rates. We do agree with credit markets that economic growth will be strong enough to avoid a recession, at least for the near term, but valuations are also counting on much lower rates, which seems to us inconsistent.

The Canadian yield curve continues to be unappealing for term investors, for anything but transient moves (as we saw this past quarter). The 2-30's yield curve has been inverted since the end of June 2022 and during that time it has spent roughly 85% of the time at -60 bps or more and 30% of the time at over -100 bps. We are not confident that the negative term premiums will disappear soon (given the preponderance of long Canadian ALM investors and the relative dearth of C$ provincial issuance), which continues to make short term investments more attractive on a risk/reward basis. In addition, the vulnerability of corporate yield spreads and the more attractive short-term spread break-evens, add to the appeal of short-term credit.

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