Short-Term Bond

December 2023

Market Highlights

As dramatic as the rise in bond yields was during Q3, the fall in Q4 was even more so. North American bond markets saw a significant repricing of yield curves in November and December following the Fed's policy pivot away from monetary tightening. Five-year US and Canadian yields declined by 76 and 107 basis points, respectively during the quarter – an abrupt reversal, especially given the much more gradual move upwards – and are now down 16 and 24 bps, respectively year-to-date. Two-year yields saw 79 and 98 bps declines in the US and Canada, respectively, despite generally being more anchored to overnight rates, which is indicated of expectations for rapid policy reversal. 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 reduced.) 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, three to five-year provincial, telecom and senior bank were purchased using the proceeds from coupon payments and the sale of provincial, telecom, and senior bank-debt maturing in less than one year.

The portfolio's duration was increased from 1.5 years to 2 years (2/3 of a year less than the benchmark) and the steepening bias increased. Credit quality biases were maintained.

What Worked in the Quarter

The portfolio was overweight provincial bonds whose yield spreads narrowed by an average of 7 bps given reduced domestic issuance, despite strong foreign demand, and credit rating upgrades (Alberta).

The portfolio benefitted from industry and issuer composition, which included an overweight in insurance, telecom and senior bank debt which outperformed. The portfolio was also underweight utility, infrastructure and oil and gas credit which underperformed.

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

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What Didn't Work in the Quarter

The portfolio was conservatively structured with an overweight in debt maturing in less than 3-years and an average duration of approximately 1.5 years, well below the benchmark duration, which was negative for relative performance given the bull flattening of the short-term yield curve.

The portfolio was underweight corporate credit by 1/4 of a year on a duration weighted basis.

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 2-5's yield has been inverted since the end of June 2022 and during that time it has spent roughly 87% of the time at -40 bps or more and 68% at -60 bps or more. 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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