Short-Term Bond

January 2024

Market Highlights

Our necks are sore from trying to follow the gyrations of the bond market these last few months – any rest they may have gotten during the holiday break was short lived. We were not convinced at year end that investors were getting it quite right – we felt yields were pushed too low and expectations of easing from both the Fed and the Bank of Canada were far too significant and premature. Anticipation of imminent knockout blows to the economy and the submission of inflation were and are unwarranted, with both appearing somewhat resistant to tighter monetary policy.

Not surprisingly, the amount of policy easing priced into markets has fallen this quarter in light of stronger-than-expected data and over-zealous Q4 bond positions. Both, the Fed and the Bank of Canada, have walked back earlier "unintended" signals of impending policy easing, emphasizing above target inflation and the need to act cautiously. Yields have risen across yield curves, with more notable moves in Canada, which has seen almost a 50% retracement of Q4's decline.

The short-term part of the Canadian market returned -0.18% in January according to the FTSE Canada Short Term Bond Index, after rising 1.51% in December; this market was up 4.11% in Q4. So far in February, markets are down a similar amount to January. Volatility continues to be a feature of bond markets, and investors are not getting well paid for owning the riskier bond varieties – either lower quality credits where yield spreads are relatively tight, or longer maturities where an inverted yield curve implies negative term premiums.

Outlook & Strategy

We believe that both the Bank of Canada and the Fed's next moves will be to lower rates. However, we doubt inflation will decline sufficiently to warrant the easing currently priced into yield curves. Notably, Bank of Canada Governor Macklen has recently commented on the Bank's rationale for differentiating between the causes of housing inflation and those of overall inflation, perhaps suggesting a willingness to act despite above target inflation data – this remains an open question and one that we are watching it carefully.

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 relative appeal of short-term credit.

Relatively tight corporate yield spreads indicate that investors expect economic growth to remain strong enough to avoid a recession, at least for the near term; however, valuations also imply investors are counting on much lower rates, which seems to us inconsistent. Consequently, we expect investors will continue to cautiously look to credit as a source of attractive yield carry. In the Canadian market, which is dominated by investment grade credits, leverage, and debt servicing metrics, even for the lowest rated credits, are healthy and refinancing risk is not a near-term threat.

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