Monthly Fixed Income Update

Hank Cunningham

November 17, 2022

Interest Rate Summary	Oct-31-22	Sep-29-22	Aug-31-22	Jul-29-22	Jun-30-22	May-31-22	Apr-29-22	Dec-31-21	Dec-31-20
U.S.									
3-Month T-Bill	4.07%	3.30%	2.93%	2.36%	1.67%	1.06%	0.83%	0.04%	0.08%
2-Year Treasury	4.49%	4.28%	3.50%	2.89%	2.96%	2.56%	2.72%	0.73%	0.12%
10-Year Treasury	4.05%	3.83%	3.20%	2.65%	3.02%	2.85%	2.94%	1.51%	0.92%
Canada									
3-Month T-Bill	3.85%	3.78%	3.23%	2.65%	2.09%	1.47%	1.44%	0.17%	0.06%
2-Year Canada	3.89%	3.79%	3.65%	2.96%	3.09%	2.66%	2.62%	0.95%	0.20%
10-Year Canada	3.25%	3.17%	3.12%	2.61%	3.22%	2.89%	2.86%	1.42%	0.68%

Performance	YTD	2021	2020	2019	2018	2017	2016
DEX Universe Bond Index	-12.68%	-2.54%	8.68%	6.87%	1.41%	2.52%	3.52%
DEX Federal Bond Index	-9.84%	-2.62%	7.28%	3.73%	2.39%	0.13%	3.66%
DEX Provincial Bond Index	-16.02%	-3.28%	9.86%	9.07%	0.66%	4.33%	4.14%
DEX All Corporate Index	-11.54%	-1.34%	8.74%	8.05%	1.10%	3.38%	2.71%
DEX “A” Corporate Index	-12.46%	-2.30%	8.98%	9.65%	0.51%	4.42%	2.62%
DEX Real Return Bonds	-16.15%	1.84%	13.02%	8.02%	-0.05%	0.72%	2.79%
DEX High Yield Bonds	-7.74%	6.18%	6.69%	8.48%	2.15%	5.20%	13.79%

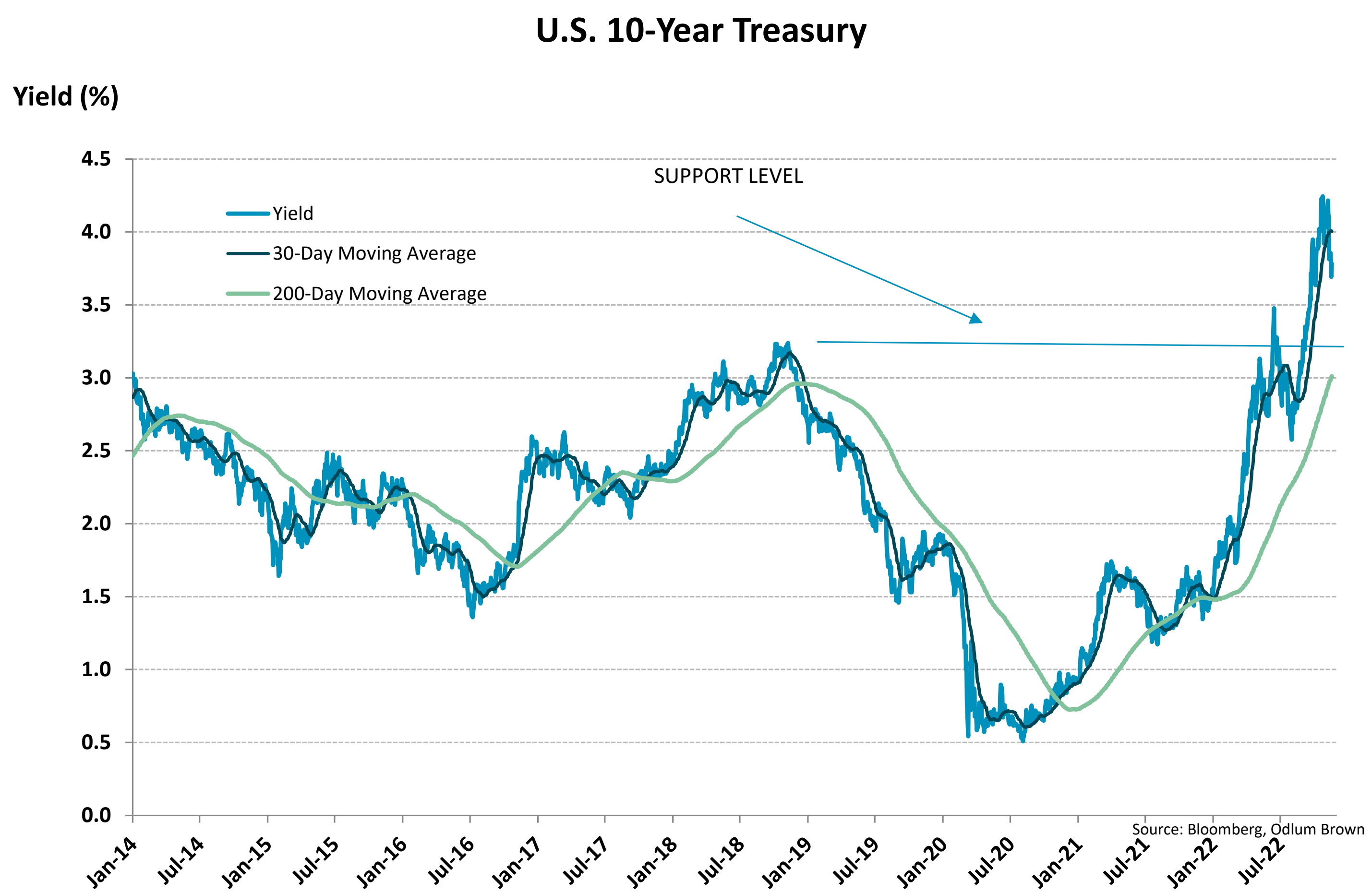
Comments

For most of October and into early November, the bond market followed the familiar script we have seen this year: Central banks raised administered rates, inflation continued to run hot and yields at all maturities rose further. U.S. two-year yields reached year-to-date peaks of 4.73% and the 10-year hit 4.24% on October 24. The Federal Reserve raised the Fed Funds Rate a further 75 basis points on November 2, the seventh consecutive increase. Then, on November 10, the CPI report offered a glimmer of hope with modest monthly declines in the overall rate and the core rate. In the aftermath, the bond market staged a giant rally with the bellwether 10-year yield falling a staggering 30 basis points to 3.81%.

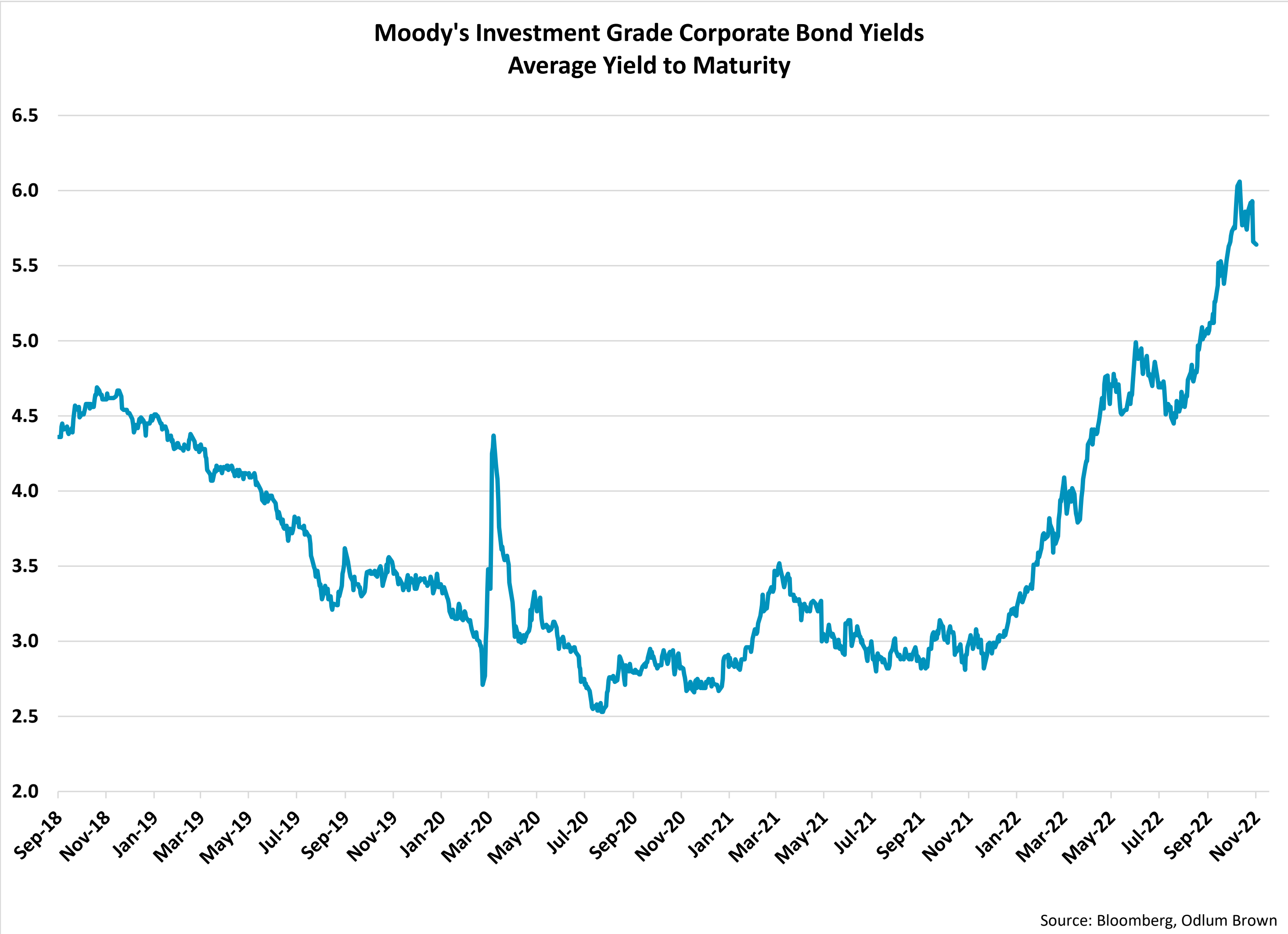
The Bank of Canada followed suit, pushing our bank rate to 3.75% and our bond market also rallied.

This occurred despite evidence that the U.S. economy had pockets of strength. While the housing market has displayed considerable weakness, the employment market remains solid with job gains exceeding estimates. The unemployment rate remains low and job openings are elevated to the tune of 10 million. In addition, retail sales have held up.

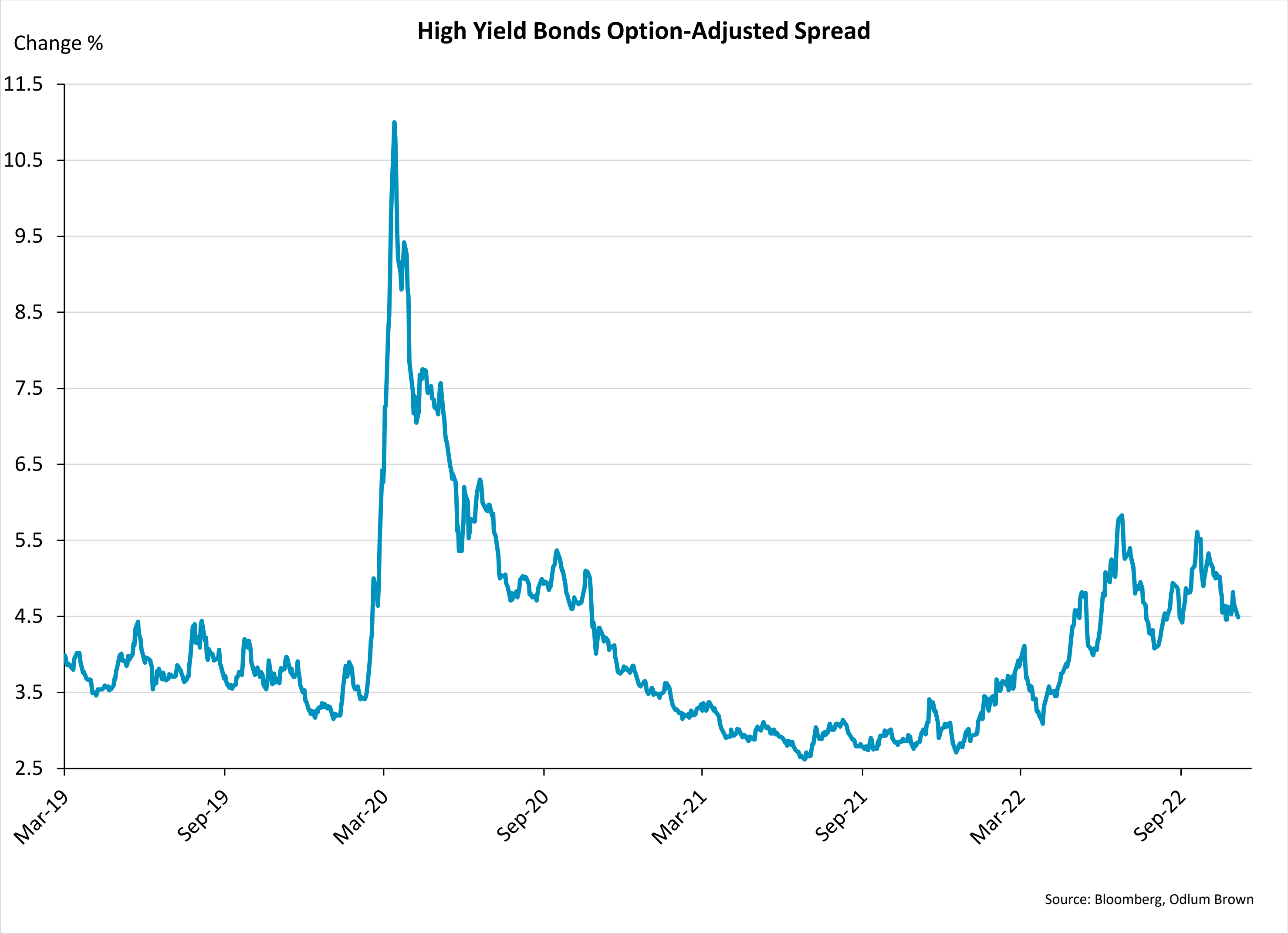
Another sign that the economy is still healthy can be found in the credit markets, where there are few signs of credit strains in either the investment-grade or the high-yield markets with yield spreads remaining at mid-range levels.



This bellwether's yield has been volatile reaching 4.25%, which is well above the previous resistance point of 3.25%. This bond yields 35 basis points less than the two-year note. This bond rallied sharply following an improved CPI number and may have entered a new trading range of 3.5% to 4.50%.



Corporate bond markets remain calm. Investment-grade corporate yields have maintained a relatively steady yield spread from government bonds.



High yield bonds have performed well, with their spreads narrowing significantly from their summer peak.

Suite 1100 – 250 Howe Street | Vancouver, BC V6C 3S9
Main 604 669 1600 | Toll Free 1 888 886 3586
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Source: Bloomberg, Odlum Brown

After being mired in negative territory, real yields have responded to monetary tightening by moving higher.

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Outlook

Inflation remains a global issue, despite the recent improvement in North America. In Europe, consumer prices have accelerated above 11% with no sign of relief. There has also been extra turbulence caused by extraordinary developments in the UK. The U.S. Federal Reserve has quashed near-term enthusiasm that its interest rate hikes are near an end. Chair Powell has stated repeatedly that he would like to see several consecutive months of improved inflation numbers before considering a pause. Thus, the Fed Funds Rate is likely to rise 50 basis points on December 14. The Canadian bank rate will likely move up a similar amount on December 7.

As to market yields, the U.S. two-year yield, currently at 4.4%, could reach 5% with further tightening and the 10-year appears to be headed to 4.25% to 4.5%. There have been few signs of strain in credit markets, but vigilance is required. Given the extent of the bond market sell off, rallies from time to time are likely. It is possible we will see 3.5% on the 10-year Treasury.

The Bank of Canada has little choice but to follow the Fed as the Canadian economy has also proved to be resilient. In addition, the Canadian dollar has suffered at the hands of a strong U.S. dollar, although it has bounced from recent lows. The weaker loonie will nevertheless exacerbate inflation trends in Canada as import prices add to domestic cost pressures.

In summary, global credit markets are discounting the next rounds of interest rate hikes. This removes the surprise factor and should result in few knee-jerk reactions. There remains the possibility that several central banks may reduce their bloated balance sheets via bond sales.

The big question is: when will we see inflation turn? One month does not make a trend. While the cost of goods has shown weakness in recent months, the biggest component of the CPI is service costs, and they show little sign of slowing and may actually increase. There are signals of a recession on the horizon, but economic growth remains positives. Odds of such an outcome have grown, but a recession is by no means a certainty. Those who believe in the inevitability of a recession point to the lagged effect of monetary tightening and suggest it has yet to be felt, other than in the interest rate-sensitive housing market. It is important to watch the corporate bond market for signals that tightening is beginning to affect credit quality.

Strategy

Inflation is the enemy of bond investors and will remain a major negative for the foreseeable future. Thus, this continues to be a time to defend principal as long-term bonds carry significant potential for capital loss if interest rates rise further. We counsel investors not to reach for yield, but instead to invest in short-term, high-quality corporate bonds. This approach will defend principal while producing modest returns. Floating-rate bonds offer the promise of higher returns with minimal risk to principal as short-term yields continue to climb.

This year's increase in corporate yields has resulted in a host of bonds, issued at lower yields, trading at significant discounts from their par values, thus creating positive after-tax opportunities. We have created the **Odlum Brown Discount Corporate Ladder** portfolio to take advantage of this opportunity.

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We are approaching the time when the end of the monetary-tightening cycle may occur, producing a peak Fed Funds Rate of at least 5%. Thus, this is a time when some modest increase in duration may be in order. This may be achieved by adding three- to five-year bonds to existing ladders, if they do not already contain any.

Floating-rate bonds have performed well this year, maintaining their market value, while their coupon income has risen to over 4%. There is at least one more boost in their coupons coming after the next Bank of Canada rate increase. Looking ahead to 2023, it may become time to pare positions in these securities.

We also continue to recommend a laddered approach using the **Odlum Brown Corporate Bond Ladder**, which features more in the way of current coupon bonds. Also, we recommend individual floating-rate bonds. The **Odlum Brown Model Portfolio** is well positioned for this market environment with a short duration and floating-rate debentures included.

We have adopted the use of outside bond investment managers to augment returns. Our top recommended funds are:

- **Picton Mahoney Liquid Alt Fund.** This is a well-managed long/short fund and is available as an ETF.
- **Canso Short-Term and Floating-Rate Fund.** This fund protects principal and takes advantage of opportunities in the floating-rate market.
- **Canso Corporate Value Fund.** This is a well-managed, long-only corporate bond fund.

Please consult your Investment Advisor or Portfolio Manager for more details and to discuss this strategy.

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