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INVESTMENT RESEARCH

Monthly Fixed Income Update

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September 9, 2022

Interest Rate Summary	Aug-31-22	Jul-29-22	Jun-30-22	May-31-22	Apr-29-22	Mar-31-22	Feb-28-22	Dec-31-21	Dec-31-20
U.S.									
3-Month T-Bill	2.93%	2.36%	1.67%	1.06%	0.83%	0.50%	0.31%	0.04%	0.08%
2-Year Treasury	3.50%	2.89%	2.96%	2.56%	2.72%	2.34%	1.43%	0.73%	0.12%
10-Year Treasury	3.20%	2.65%	3.02%	2.85%	2.94%	2.34%	1.83%	1.51%	0.92%
Canada									
3-Month T-Bill	3.23%	2.65%	2.09%	1.47%	1.44%	0.73%	0.57%	0.17%	0.06%
2-Year Canada	3.65%	2.96%	3.09%	2.66%	2.62%	2.29%	1.43%	0.95%	0.20%
10-Year Canada	3.12%	2.61%	3.22%	2.89%	2.86%	2.40%	1.81%	1.42%	0.68%

Performance	YTD	2021	2020	2019	2018	2017	2016
DEX Universe Bond Index	-11.31%	-2.54%	8.68%	6.87%	1.41%	2.52%	3.52%
DEX Federal Bond Index	-9.07%	-2.62%	7.28%	3.73%	2.39%	0.13%	3.66%
DEX Provincial Bond Index	-14.30%	-3.28%	9.86%	9.07%	0.66%	4.33%	4.14%
DEX All Corporate Index	-9.88%	-1.34%	8.74%	8.05%	1.10%	3.38%	2.71%
DEX "A" Corporate Index	-10.63%	-2.30%	8.98%	9.65%	0.51%	4.42%	2.62%
DEX Real Return Bonds	-14.56%	1.84%	13.02%	8.02%	-0.05%	0.72%	2.79%
DEX High Yield Bonds	-6.41%	6.18%	6.69%	8.48%	2.15%	5.20%	13.79%

Comments

Bond yields reversed course again and are now challenging their 2022 highs. The U.S. two-year treasury yield at 3.50% and the 10-year yield at 3.35% are 275 and 185 basis points higher, respectively, from year-end levels. Year-to-date performance overall is close to the worst in history. While there were fears in July and August of a recession and hopes of retreating inflation, this optimism was dashed with a hawkish speech by Fed Chair Powell at the Jackson Hole conference on August 26. He left no doubt that the Fed would not ease monetary conditions anytime soon and that the market should expect further significant increases in the Fed Funds Rate. The bond market sold off immediately afterwards.

Supporting the Fed's hawkishness is a resilient economy. ISMs have been supportive and the employment market shows little sign of weakness. Consumer sentiment has bounced higher. However, the housing market has displayed widespread softening in prices, sales, housing starts and building permits.

Inflation has been the key statistic this year. The Consumer Price Index (CPI) reading was 8.5% for July on a year-over-year basis, down from the recent high of 9.1% and shows signs of ebbing further.

Importantly, the labour market remained taut with the unemployment rate hitting 3.5% and wage pressures growing, with increases beginning to settle in at 5%. There are 10.7 million job openings in America, far more than the number of unemployed.

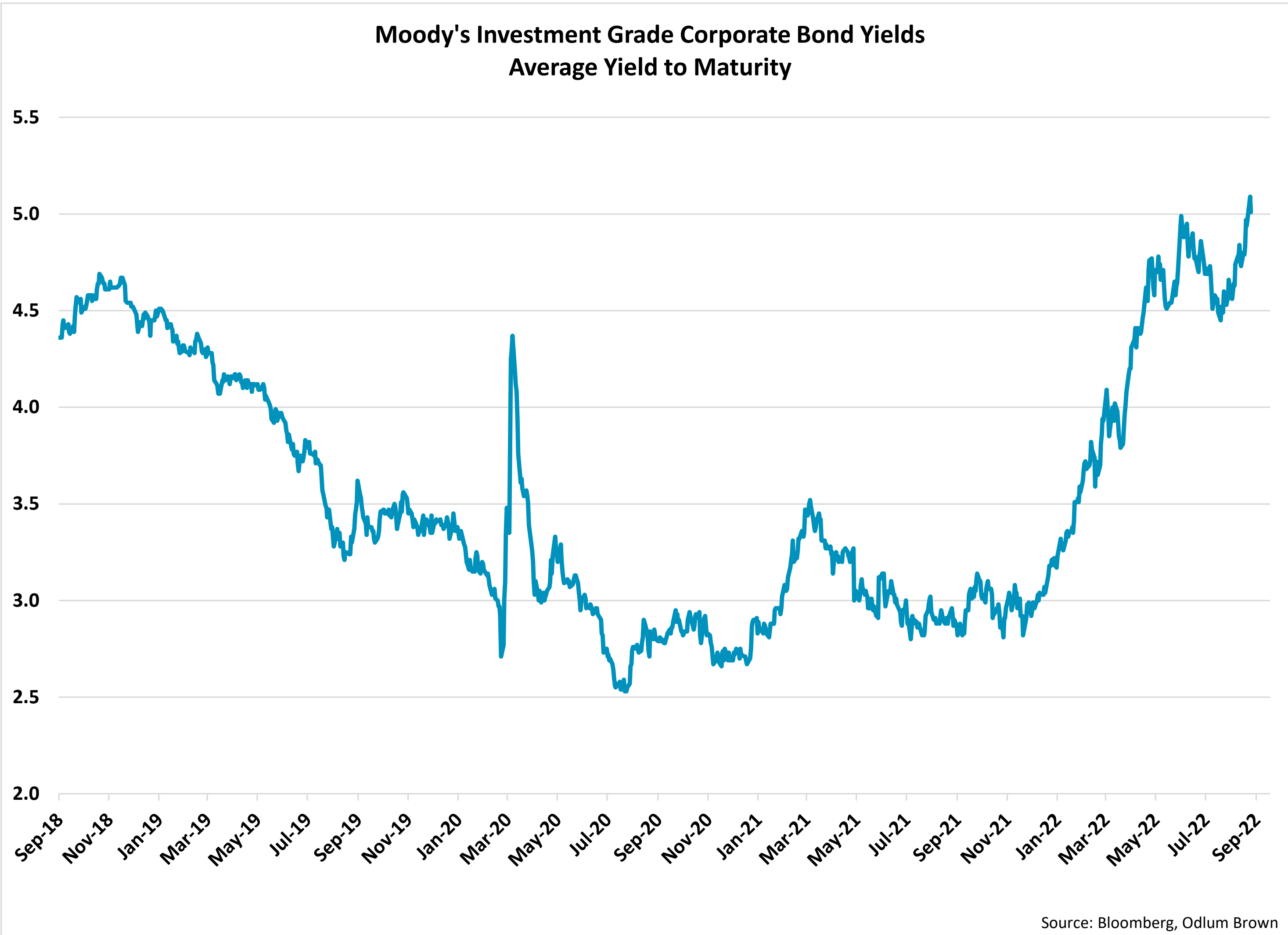
Canada has also enjoyed buoyant economic times with three consecutive trade surplus prints, two of them records. However, the Canadian economy shed jobs for three straight months, with the unemployment rate jumping to 5.4%.

The Bank of Canada, on September 7, hiked its key lending rate by 75 basis points to 3.25%; this is an annual cumulative increase of 300 basis points and puts the rate at its highest since 2008.

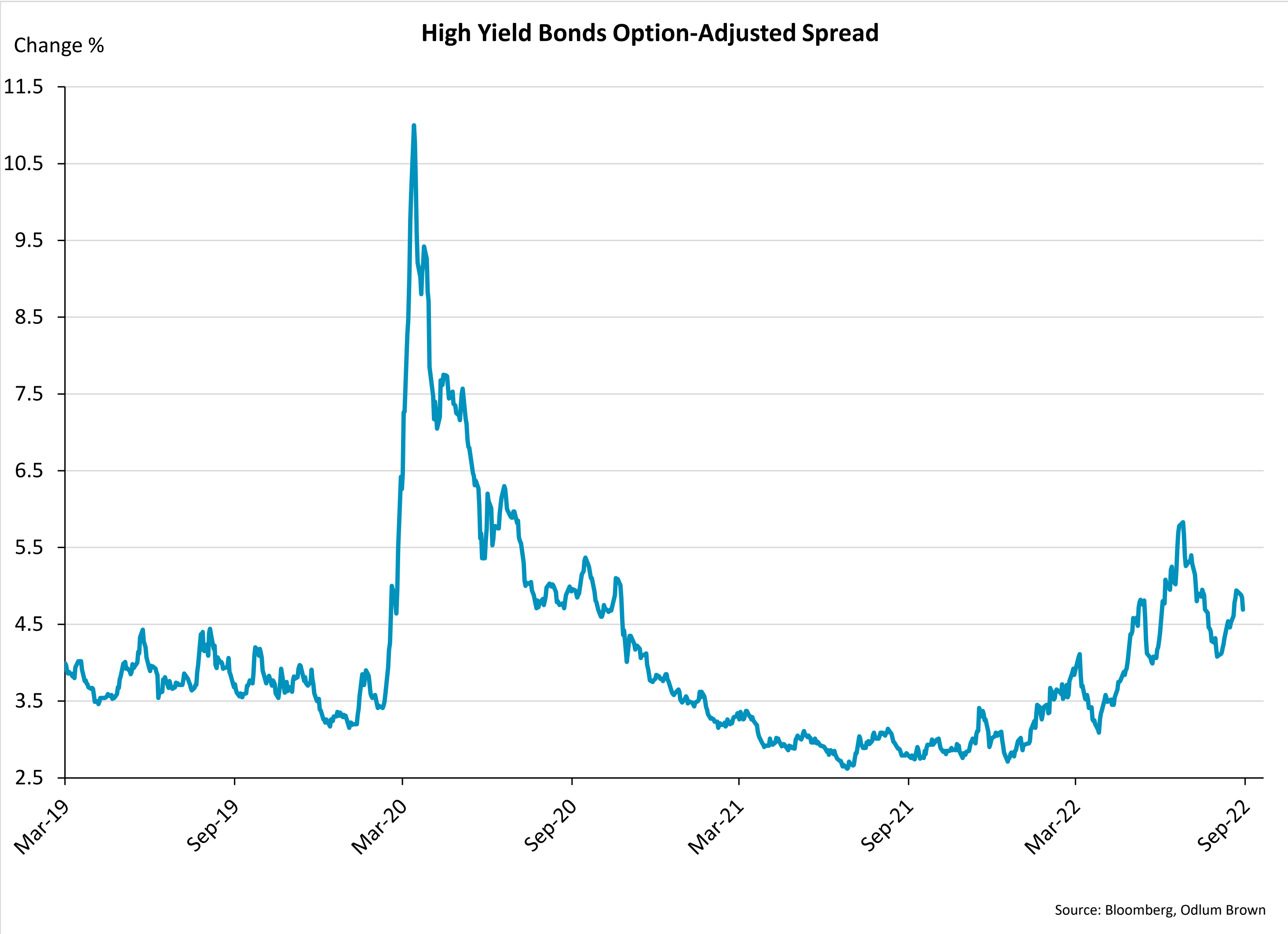
The corporate bond market, in both the U.S. and Canada, remains healthy, although there are signs of credit strain becoming visible and spreads have widened modestly from Treasury yields.

U.S. 10-Year Treasury

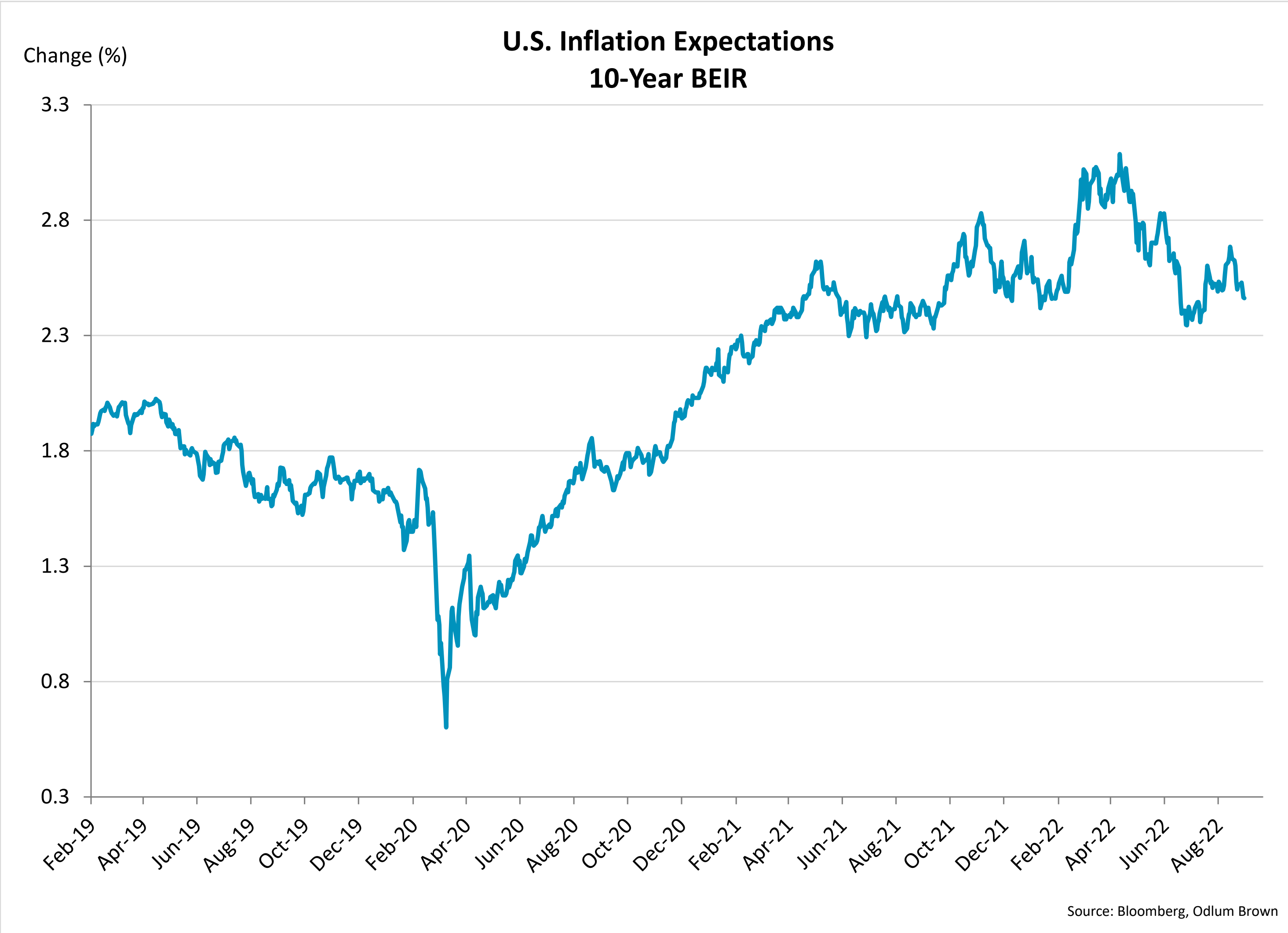
This bellwether's yield has been volatile, ranging from 3.5% to 2.5% and has settled in the 3.25% level, an important resistance point. This bond is 25 basis points lower in yield than the two-year. With more Fed tightening to come, further upward pressure on bond yields is likely.



Investment-grade corporate yields moved higher along with government bond yields, with some modest widening of yield spreads.



After a strong rally, high yield bonds have risen sharply with government bond yields. Credit conditions remain stable.



Inflation expectations have been declining steadily after peaking in late April. Other measures of expectations have ebbed as well, signaling a possible break in the inflation cycle.

Outlook

The monetary tightening, only recently begun, is starting to impact economic growth prospects. In the U.S., GDP was negative for two consecutive quarters, accompanied by an inversion of the yield curve. These are traditional barometers of a recession. Global economic forecasts have been tempered but are still positive. Housing markets have softened noticeably, while commodity prices have endured a severe correction.

After the recent cooling in the CPI, speculation was rife that the Fed will only hike its rate by a further 50 basis points. These hopes were quashed by a hawkish speech from Fed Chair Powell at the recent Jackson Hole gathering. The Fed is on record for wanting to see several sequential months of improvement in the inflation trends before considering any change in its stance.

The Bank of Canada, after hiking its key lending rate by a further 75 basis points, indicated that further hikes are coming. The Bank is concerned that inflation is becoming entrenched. The Bank of Canada stated that the economy remained strong and that wage increases were accelerating.

The ECB joined the tightening crowd, hiking its key rate by an unprecedented 75 basis points, while downgrading Europe's growth prospects.

We expect the U.S. 10-year Treasury yield to expand, perhaps reaching 3.5%. Corporate bond yields will track government yields closely as credit conditions are still positive but as modest strains have emerged of late. Some widening from Treasury yields is likely.

Wage pressures are escalating and have moved to the 5% plus level and may prevent the inflation rate from falling back to 2%. Long-term deflationary pressures, such as demographics and technology, will re-emerge eventually and help ease inflation. Overall, inflation will be slow to subside, with most forecasts, including those from the central banks, estimating it to land between 4-5% this year. Inflation indicators, such as break-even rates, have softened noticeably lately.

Already, the market has discounted several further rate hikes and thus markets are not likely to react in a knee-jerk fashion. The Fed, and other central banks, remain committed to normalizing short-term interest rates in the belief that moving rates to the 4% area will not affect economies unduly.

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 potential of higher returns with minimal risk to principal as short-term yields continue to climb.

The increase in corporate bond yields this year 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 recommend a laddered approach using the **Odlum Brown Corporate Bond Ladder**. Also, we recommend individual floating-rate bonds. The Odlum Brown Bond Model Portfolio is also well positioned for this market environment.

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.