Monthly Fixed Income Update

Hank Cunningham **April 26, 2023**

Interest Rate Summary	Mar-31-23	Feb-28-23	Jan-31-23	Dec-30-22	Nov-30-22	Oct-31-22	Sep-29-22	Aug-31-22	Jul-29-22
U.S.									
3-Month T-Bill	4.75%	4.81%	4.67%	4.37%	4.35%	4.07%	3.30%	2.93%	2.36%
2-Yr Treasury	4.03%	4.82%	4.20%	4.43%	4.31%	4.49%	4.28%	3.50%	2.89%
10-Yr Treasury	3.47%	3.92%	3.51%	3.88%	3.61%	4.05%	3.83%	3.20%	2.65%
Canada									
3-Month T-Bill	4.38%	4.50%	4.40%	4.24%	3.99%	3.85%	3.78%	3.23%	2.65%
2-Year Canada	3.73%	4.20%	3.75%	4.05%	3.87%	3.89%	3.79%	3.65%	2.96%
10-Year Canada	2.90%	3.33%	2.91%	3.30%	2.94%	3.25%	3.17%	3.12%	2.61%

Performance	YTD*	2022	2021	2020	2019	2018	2017
DEX Universe Bond Index	3.96%	-11.69%	-2.54%	8.68%	6.87%	1.41%	2.52%
DEX Federal Bond Index	0.46%	-9.34%	-2.62%	7.28%	3.73%	2.39%	0.13%
DEX Provincial Bond Index	0.69%	-15.05%	-3.28%	9.86%	9.07%	0.66%	4.33%
DEX All Corporate Index	1.14%	-11.54%	-1.34%	8.74%	8.05%	1.10%	3.38%
DEX "A" Corporate Index	1.19%	-9.87%	-2.30%	8.98%	9.65%	0.51%	4.42%
DEX Real Return Bonds	0.84%	-14.32%	1.84%	13.02%	8.02%	-0.05%	0.72%
DEX High Yield Bonds	0.54%	-5.44%	6.18%	6.69%	8.48%	2.15%	5.20%

**As of April 26, 2023*

Comments

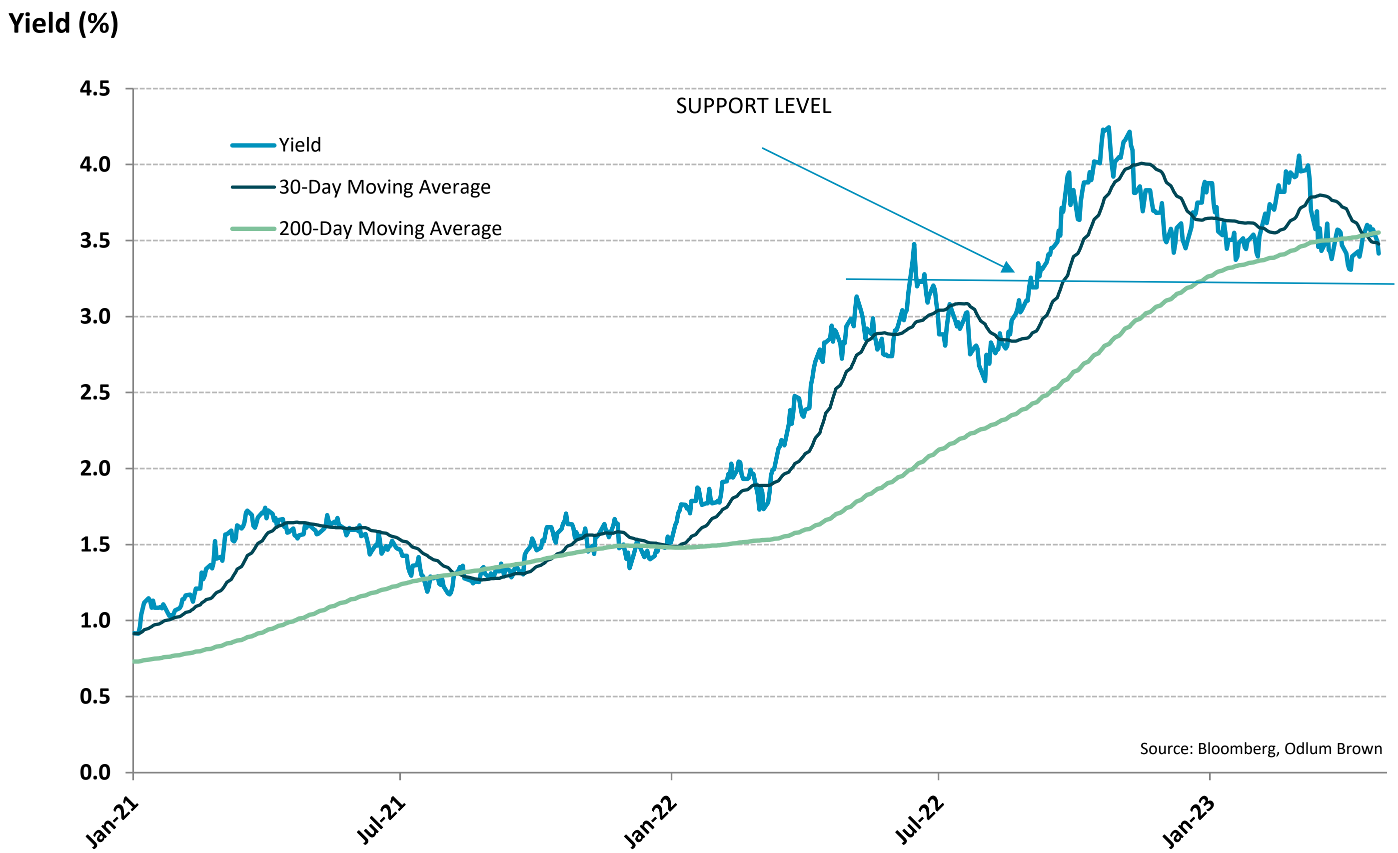
After plummeting in the wake of the regional bank crisis in the United States, bond yields have moved steadily higher at all maturities. From a peak of 5.07% on March 8, the U.S. two-year note plunged to 3.77% on March 24 and has bounced up to 4.02% currently. Similarly, the bellwether 10-year note fell from 4% to 3.30% and has since moved up to 3.42%.

Corporate bonds yield spreads widened immediately from governments, by as much as 100 basis points for high yield bonds. New issuances of corporate bonds ground to a halt. At present, investment-grade and high yield corporate spreads have narrowed from pre-crisis levels and new issuances have resumed.

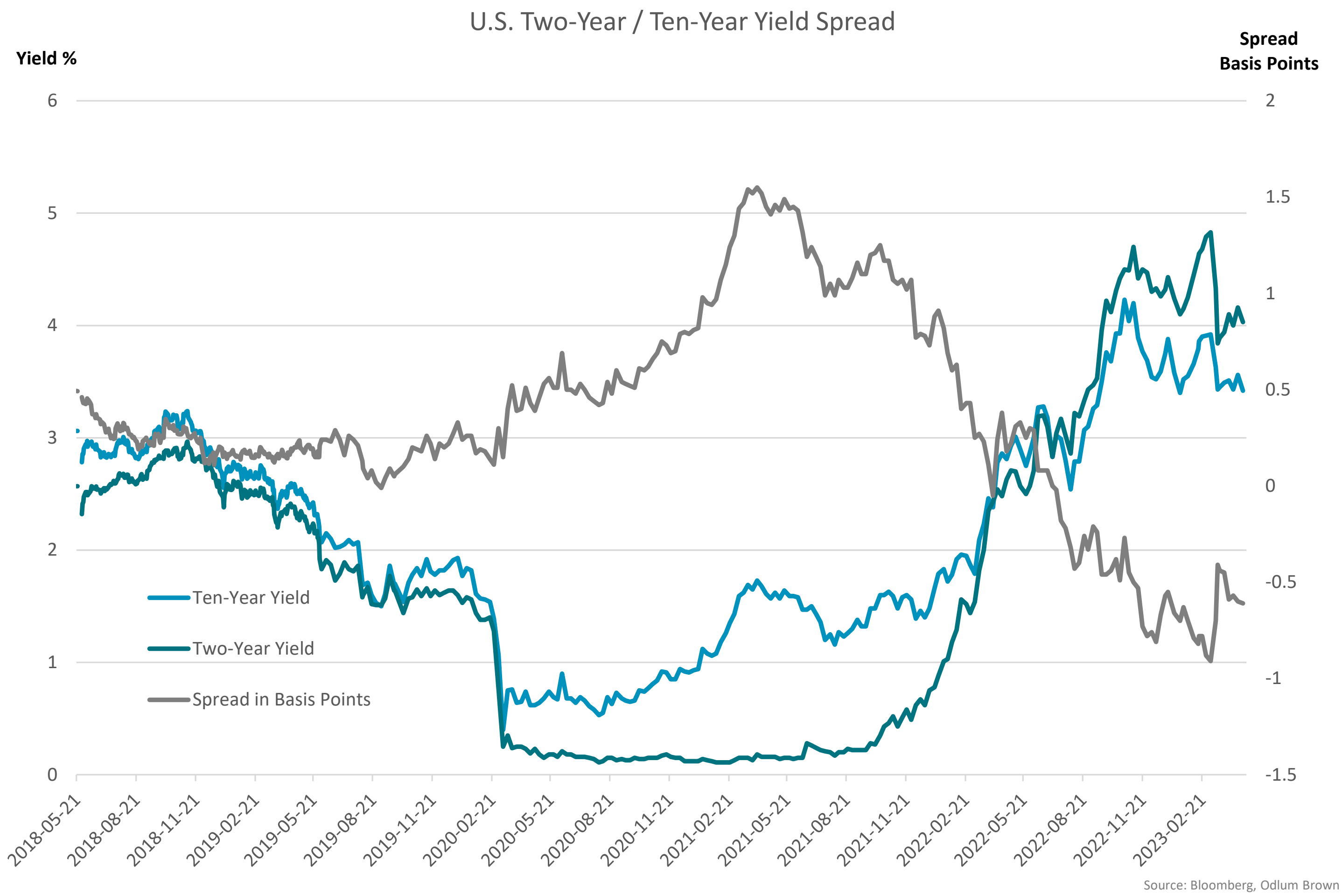
On March 8, Fed Chair Powell gave a particularly hawkish speech, leaving little doubt that the Fed was not done raising rates. The Fed raised its rate a further 25 basis points on March 22, and left the door open for at least one more such increase. Canada is facing weakness in GDP and is sensitive to a large percentage of variable-rate mortgages. The Bank of Canada paused, as it promised to do, leaving its rate at 4.5% on March 8. This may be the peak for Canadian policy rates.

Thus far in April, inflation has softened further, retail sales have slumped and consumer confidence has ebbed significantly. Yet, price pressures remain persistent, especially in the services sector and the employment market remains taut. GDP growth is still positive as well.

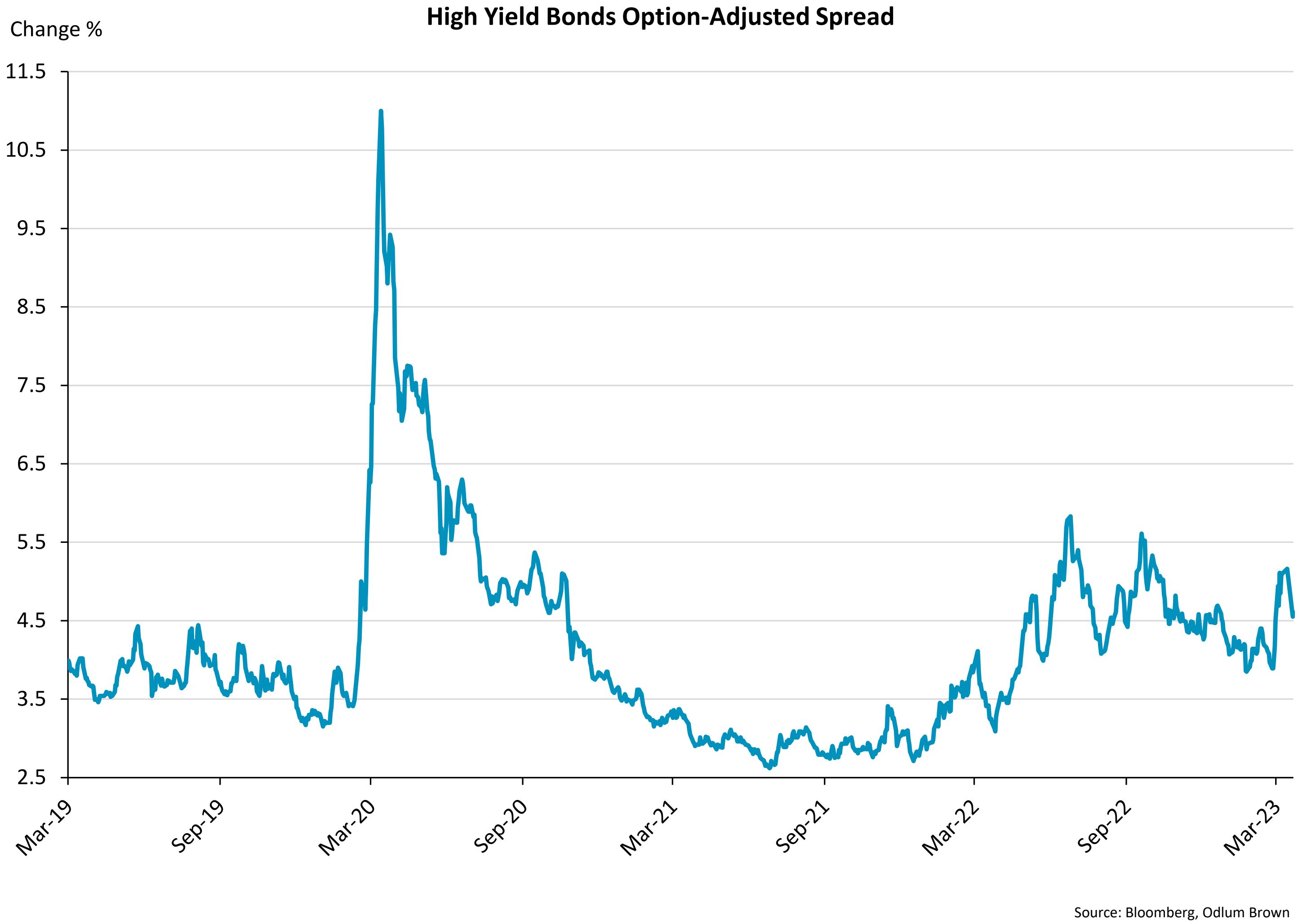
U.S. 10-Year Treasury



This bellwether bond is at a critical juncture as its yield has converged with its moving averages.



The yield curve remains inverted but at lower spreads than before the regional bank crisis.



High yield bonds, after rising by 100 basis points during the regional bank crisis, have narrowed back to pre-crisis spreads.

Outlook

Global growth prospects have deteriorated, with the IMF downgrading its outlook. In light of recent developments in the banking industry, the global economy will be fragile. Recession forecasts are growing, and some are concerned about an impending credit contraction.

Inflation may have peaked in the developed world, but it is moving only grudgingly lower and will likely not reach central bank targets anytime soon. Central banks have not finished their tightening cycles and further hikes in official rates are in the cards, as presaged by several Federal Reserve spokespeople.

Without doubt, there have been increasing signs of slowing economic activity, particularly in retail sales, manufacturing and the heretofore robust employment market.

Will there be a recession? More time is required to gauge how the monetary tightening over the past year has impacted the economy. As well, there are concerns that a credit crunch could occur as lending standards tighten. Pockets of economic strength remain, and most forecasts are for modest positive GDP growth.

Central banks will likely retain their restrictive stances for the balance of the year; inflation will remain the overriding concern and with some recent setbacks in core inflation, both in North America and overseas, it is possible that bond yields could move back up. However, it is more likely that the 10-year yield will gravitate to the 3.25% level, given the growing weakness in the economy. Also, it is premature to forecast any reversal in central bank monetary policy.

Consumer confidence has been dealt a huge blow, which may contribute to a meaningful near-term contraction in economic activity. Already, retail sales have markedly declined. Fed tightening over the past 14 months is working its way through the system and the recent liquidity calamity is evidence that tightening is straining the U.S. economy. Once this passes, and it will, market participants will re-focus on inflation, the economy and the Federal Reserve.

Inflation remains the number one issue facing fixed income markets and investors. After slowing over the previous four months, inflation in the U.S. is picking up again, particularly in the important services sector where wage growth is accelerating. It is premature to measure the impact of monetary tightening to date as it takes time to work its way through economies. With recent data exceeding estimates and inflation still high, central banks will most likely continue to tighten.

The yield curve will stay inverted for a while, but it has normalized meaningfully of late. In the meantime, fixed income investors can earn 2% to 5% plus on short-duration bonds, thus producing positive returns with minimal risk to principal.

In summary, there will be more drama and wild fluctuations in bond yields, and we still expect a wide trading range of 3.25% to 4.25% on the U.S. 10-year Treasury bond. It approached 3.25% but has bounced back up to 3.42%.

Strategy

Inflation is the enemy of bonds and will continue to be a major negative for the foreseeable future. Defending principal remains paramount. We continue to advocate the use of floating rate debentures, whose coupons are now above 5% and should stay there if central banks pause, in combination with a one- to five-year ladder of high-quality corporate and provincial bonds. We continue to advocate high-quality bonds in fixed income portfolios. There is a distinct possibility of some stress developing in corporate credit, and so we also recommend adding provincial bonds to portfolios.

This year’s increase in corporate yields has resulted in a host of bonds issued at lower yields and trading at deep discounts to their par values, thus creating positive after-tax opportunities. While most of these have rallied, considerable discounts remain. We have created the **Odlum Brown Discount Corporate Ladder** portfolio to take advantage of this opportunity.

We are now close to the end of the monetary-tightening cycle, with a peak Fed Funds Rate of at least 5.0%. We recommend a modest increase in duration, opting to maintain positions in floating rate debentures and adding four- and five-year Government of Canada and provincial bonds to existing ladders.

We also recommend using the **Odlum Brown Corporate Bond Ladder**, which features more current coupon bonds in combination with 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.