



MONTHLY FIXED INCOME UPDATE

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Interest Rate Summary	Jan-31-23	Dec-30-22	Nov-30-22	Oct-31-22	Sep-29-22	Aug-31-22	Jul-29-22	Jun-30-22	Dec-31-21
U.S.									
3-Month T-Bill	4.67%	4.37%	4.35%	4.07%	3.30%	2.93%	2.36%	1.67%	0.04%
2-Yr Treasury	4.20%	4.43%	4.31%	4.49%	4.28%	3.50%	2.89%	2.96%	0.73%
10-Yr Treasury	3.51%	3.88%	3.61%	4.05%	3.83%	3.20%	2.65%	3.02%	1.51%
Canada									
3-Month T-Bill	4.40%	4.24%	3.99%	3.85%	3.78%	3.23%	2.65%	2.09%	0.17%
2-Year Canada	3.75%	4.05%	3.87%	3.89%	3.79%	3.65%	2.96%	3.09%	0.95%
10-Year Canada	2.91%	3.30%	2.94%	3.25%	3.17%	3.12%	2.61%	3.22%	1.42%

Performance	YTD	2022	2021	2020	2019	2018	2017
DEX Universe Bond Index	0.39%	-11.69%	-2.54%	8.68%	6.87%	1.41%	2.52%
DEX Federal Bond Index	0.09%	-9.34%	-2.62%	7.28%	3.73%	2.39%	0.13%
DEX Provincial Bond Index	0.28%	-15.05%	-3.28%	9.86%	9.07%	0.66%	4.33%
DEX All Corporate Index	0.98%	-11.54%	-1.34%	8.74%	8.05%	1.10%	3.38%
DEX "A" Corporate Index	0.98%	-9.87%	-2.30%	8.98%	9.65%	0.51%	4.42%
DEX Real Return Bonds	-1.47%	-14.32%	1.84%	13.02%	8.02%	-0.05%	0.72%
DEX High Yield Bonds	1.66%	-5.44%	6.18%	6.69%	8.48%	2.15%	5.20%

Comments

The bond market roared out of the gates in January, pushing yields sharply lower. This rally proved to be premature as the market was misguided in thinking the Federal Reserve was done hiking rates and would ease them later this year.

Inflation did not melt away as witnessed in the wholesale and retail inflation prints as well as accelerating wage increases. The Fed's favourite inflation gauge – CORE PCE – also came in significantly hotter than consensus estimates.

The bond market also realized it would have to absorb \$2 trillion of U.S. Treasury bonds to fund President Biden's ambitious fiscal program. On top of this additional supply, there is a specter of Japanese investors continuing to unload their massive U.S. bond holdings in response to a shift from the Bank of Japan's easing of its yield control policy. It is the last central bank to tighten.

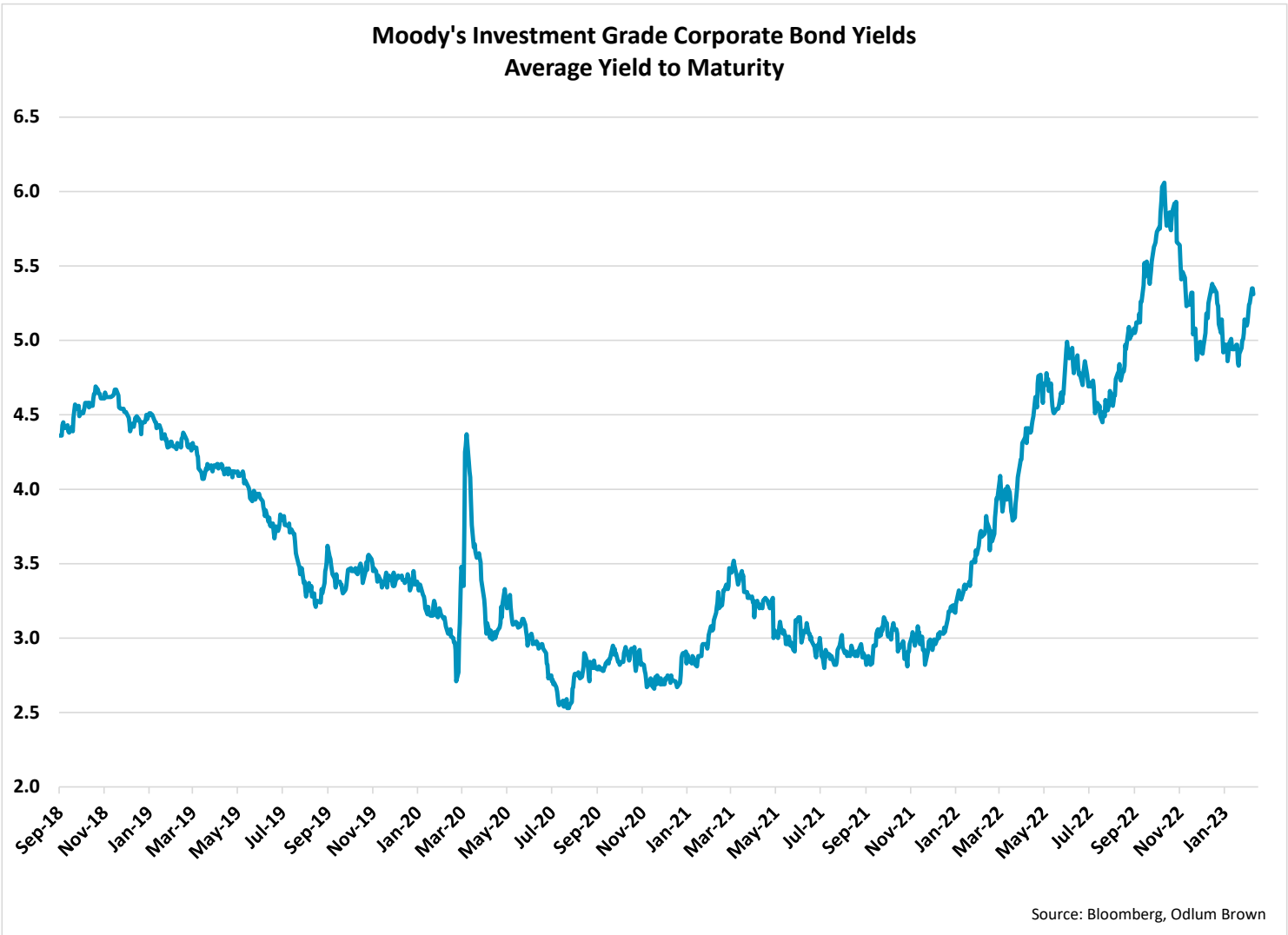
Thus far in February, bond yields have reversed course and are higher than year-end levels. This is not only in response to disappointing inflation news, but also reflecting surprisingly solid economic data. Corporate bonds, both investment grade and high yield, have been well behaved, demonstrating almost no stress.

The Bank of Canada added 25 basis points to its rate on January 25, bringing the overnight rate to 4.5%. It also signaled that it might pause as it measures the impact of previous hikes on the economy.

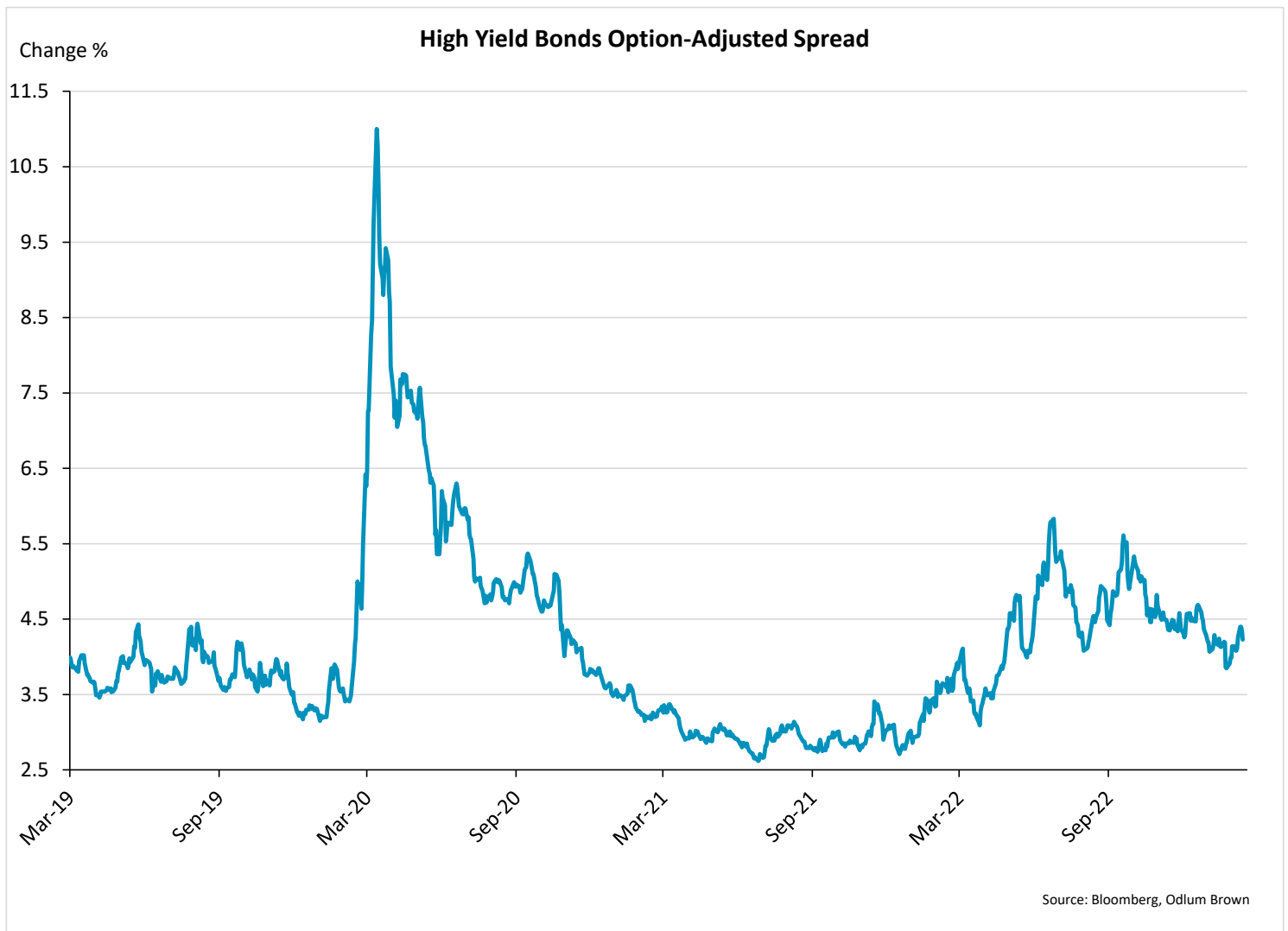
U.S. 10-Year Treasury



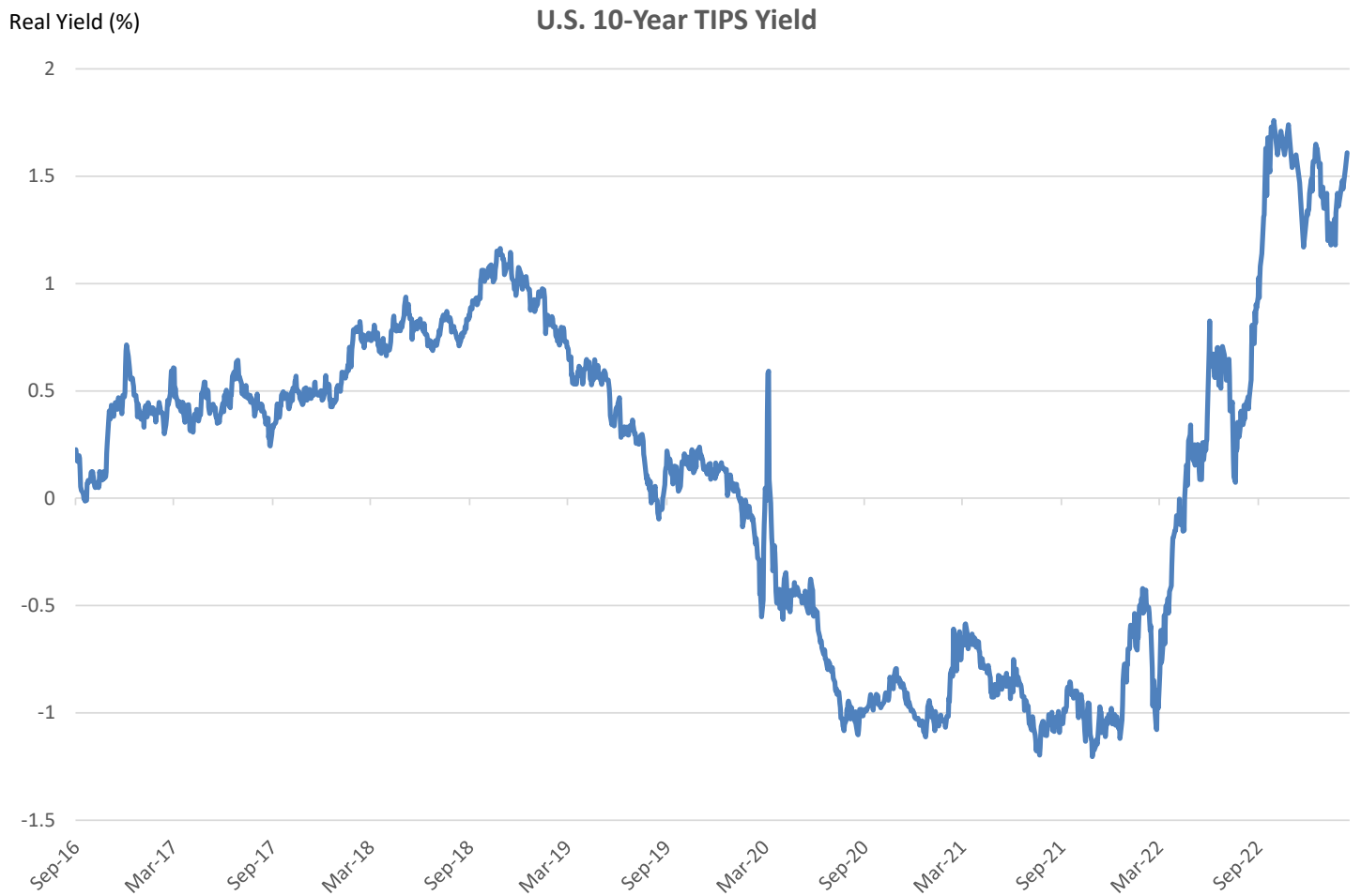
This bellwether’s yield has been volatile reaching 4.25%, which is well above the previous resistance point of 3.25%. This bond fell 75 basis points from its peak in January and has now rebounded to the 4% region. It may challenge the 4.25% resistance level in the near term.



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



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



Source: Bloomberg, Odium Brown

After being mired in negative territory, real yields have responded to monetary tightening by moving higher. Recently, their yield has tracked higher with nominal yields.

Outlook

Inflation is the number one issue facing fixed income markets and investors. It remains at elevated levels, with recent prints exceeding consensus estimates. Inflation has slowed in the past four months but shows signs of 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 for it to work its way through economies.

With recent economic data exceeding estimates and inflation still high, central banks will continue to tighten. Currently, the market, after fighting the Fed again and losing, foresees the Fed Funds Rate reaching 5.5%. That might not be the terminal rate but wherever it is, it is likely that it will stay there for the balance of 2023. The Bank of Canada may not follow in lockstep as it is concerned about the high proportion of variable rate mortgages needing to be refinanced at today's higher rates.

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

In summary, there will be more chapters in the bond market drama, and we expect a wide trading range of 3.25% to 4.25% on the U.S. 10-year Treasury bond. It is rapidly approaching 4% and will likely hit the upper end of our forecast level.

Strategy

Inflation is the enemy of bonds and will be a major negative for the foreseeable future. This is a time to defend principal. We advocate the use of floating rate debentures, whose coupons are now above 5% and should stay there as central banks are likely to pause. In combination with a one- to five-year corporate ladder, returns should be positive.

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.

We are not close to the end of the monetary-tightening cycle, with a peak Fed Funds Rate of at least 5.5%. We do not recommend any increase in duration, rather opting to maintain positions in floating rate debentures plus high-quality two- to three-year corporate bonds.

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.

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