ODLUM BROWN
Investing for Generations®

INVESTMENT RESEARCH

MONTHLY FIXED INCOME UPDATE

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July 18, 2023

Interest Rate Summary	Jun 30-23	May 31-23	Apr 28-23	Mar-31-23	Feb-28-23	Jan-31-23	Dec-30-22	Nov-30-22	Oct-31-22
U.S.									
3-Month T-Bill	5.30%	5.40%	5.06%	4.75%	4.81%	4.67%	4.37%	4.35%	4.07%
2-Yr Treasury	4.90%	4.41%	4.00%	4.03%	4.82%	4.20%	4.43%	4.31%	4.49%
10-Yr Treasury	3.84%	3.65%	3.43%	3.47%	3.92%	3.51%	3.88%	3.61%	4.05%
Canada									
3-Month T-Bill	4.91%	4.64%	4.43%	4.38%	4.50%	4.40%	4.24%	3.99%	3.85%
2-Year Canada	4.58%	4.22%	3.65%	3.73%	4.20%	3.75%	4.05%	3.87%	3.89%
10-Year Canada	3.27%	3.19%	2.84%	2.90%	3.33%	2.91%	3.30%	2.94%	3.25%

Performance	YTD*	2022	2021	2020	2019	2018	2017
DEX Universe Bond Index	1.57%	-11.69%	-2.54%	8.68%	6.87%	1.41%	2.52%
DEX Federal Bond Index	0.69%	-9.34%	-2.62%	7.28%	3.73%	2.39%	0.13%
DEX Provincial Bond Index	1.85%	-15.05%	-3.28%	9.86%	9.07%	0.66%	4.33%
DEX All Corporate Index	2.47%	-11.54%	-1.34%	8.74%	8.05%	1.10%	3.38%
DEX "A" Corporate Index	2.47%	-9.87%	-2.30%	8.98%	9.65%	0.51%	4.42%
DEX Real Return Bonds	-2.55%	-14.32%	1.84%	13.02%	8.02%	-0.05%	0.72%
DEX High Yield Bonds	2.88%	-5.44%	6.18%	6.69%	8.48%	2.15%	5.20%

**As of July 17, 2023*

Comments

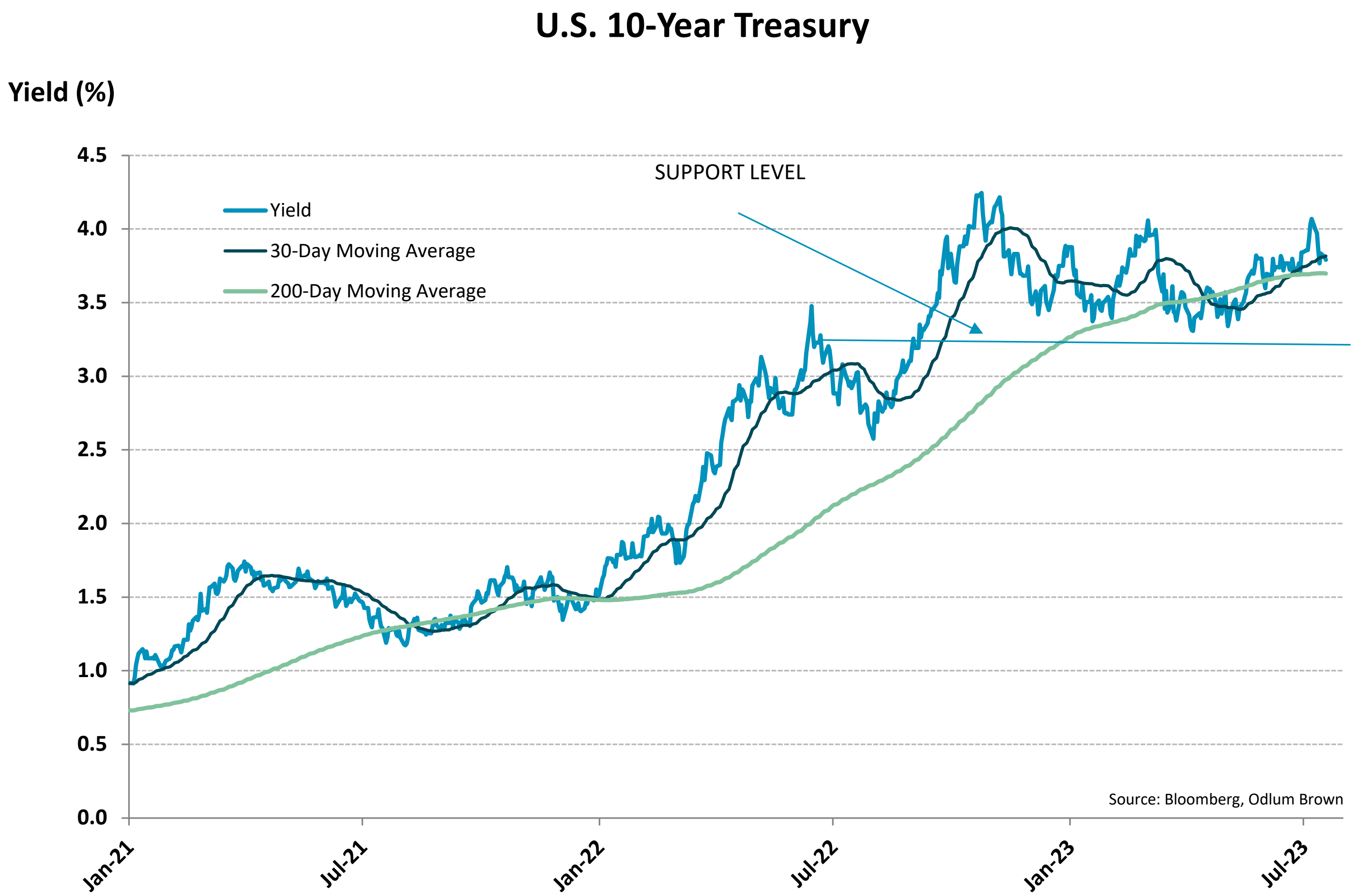
Bond yields trended higher in June and continued to rise in early July, with the 10-year Treasury note reaching 4.07% on July 7. The yield has settled back to 3.77% since. The two-year Treasury note has also been volatile, moving up from 4.50% to 5% and then lower to 4.70%. The principal reasons for the rise in yields can be found in stubborn core inflation rates, a still strong employment sector, an impressive rebound in consumer confidence and sentiment, and a still-buoyant housing market.

Following the surge in yields, the CPI report on July 11 turned heads, with more weakness in headline and core inflation than had been the consensus, and the market rallied by 25 basis points on the 10-year bellwether.

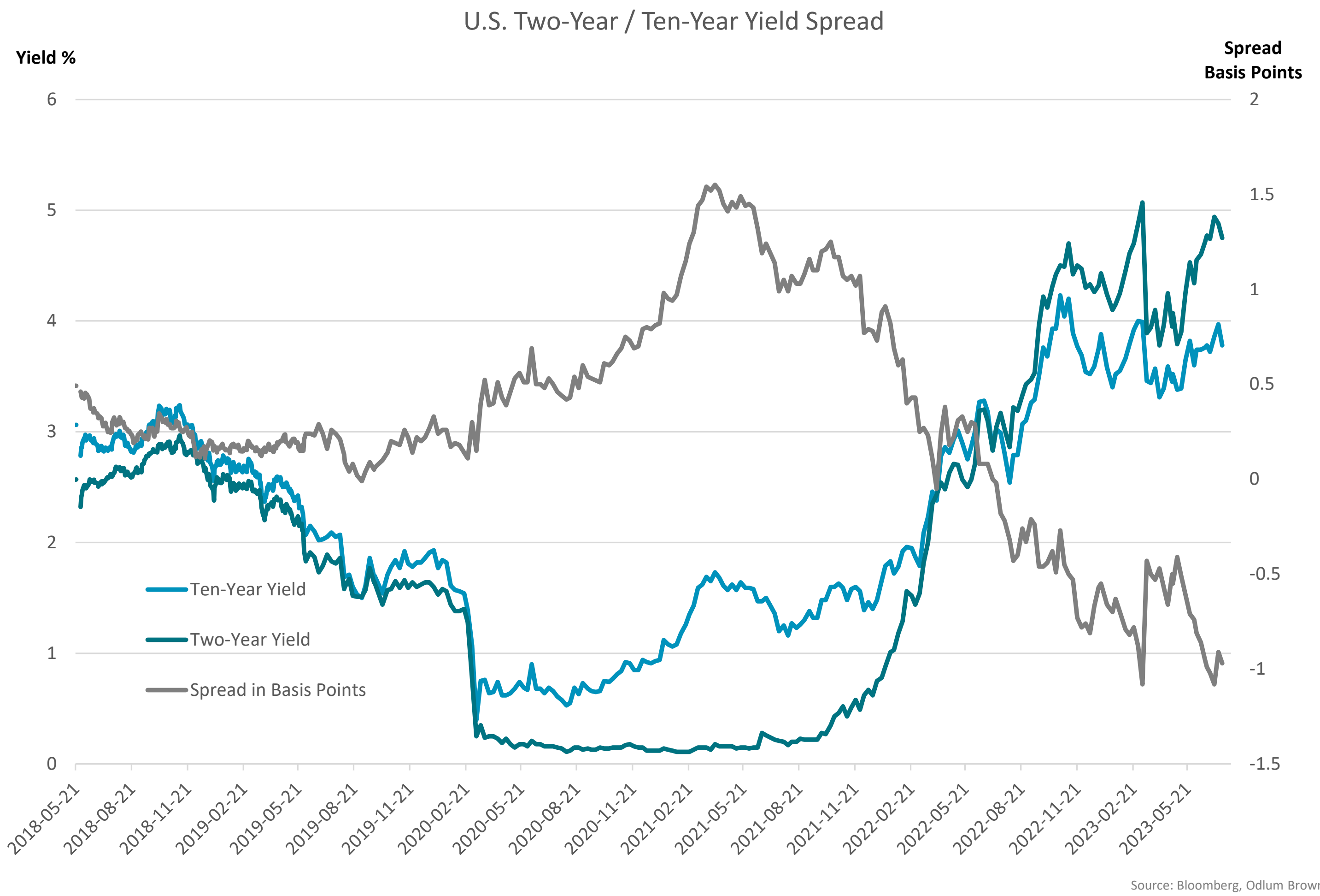
On the central bank watch, the Fed paused, as was foreseen on June 14, although Fed Chair Powell still warned of possibly two more hikes, the next one being on July 26. The Bank of Canada raised its key lending rate twice, on June 7 and on July 11 by 25 basis points each time, putting the rate at 5%. The Bank of England surprised the market with a 50-basis point hike.

Corporate bond markets remained stable, with both investment-grade and high-yield bonds registering narrower spreads from U.S. Treasury yields. This was despite increasing chatter about a possible credit crunch emerging. High-yield spreads narrowed to their tightest to Treasurys in a year. Investment-grade bonds similarly improved.

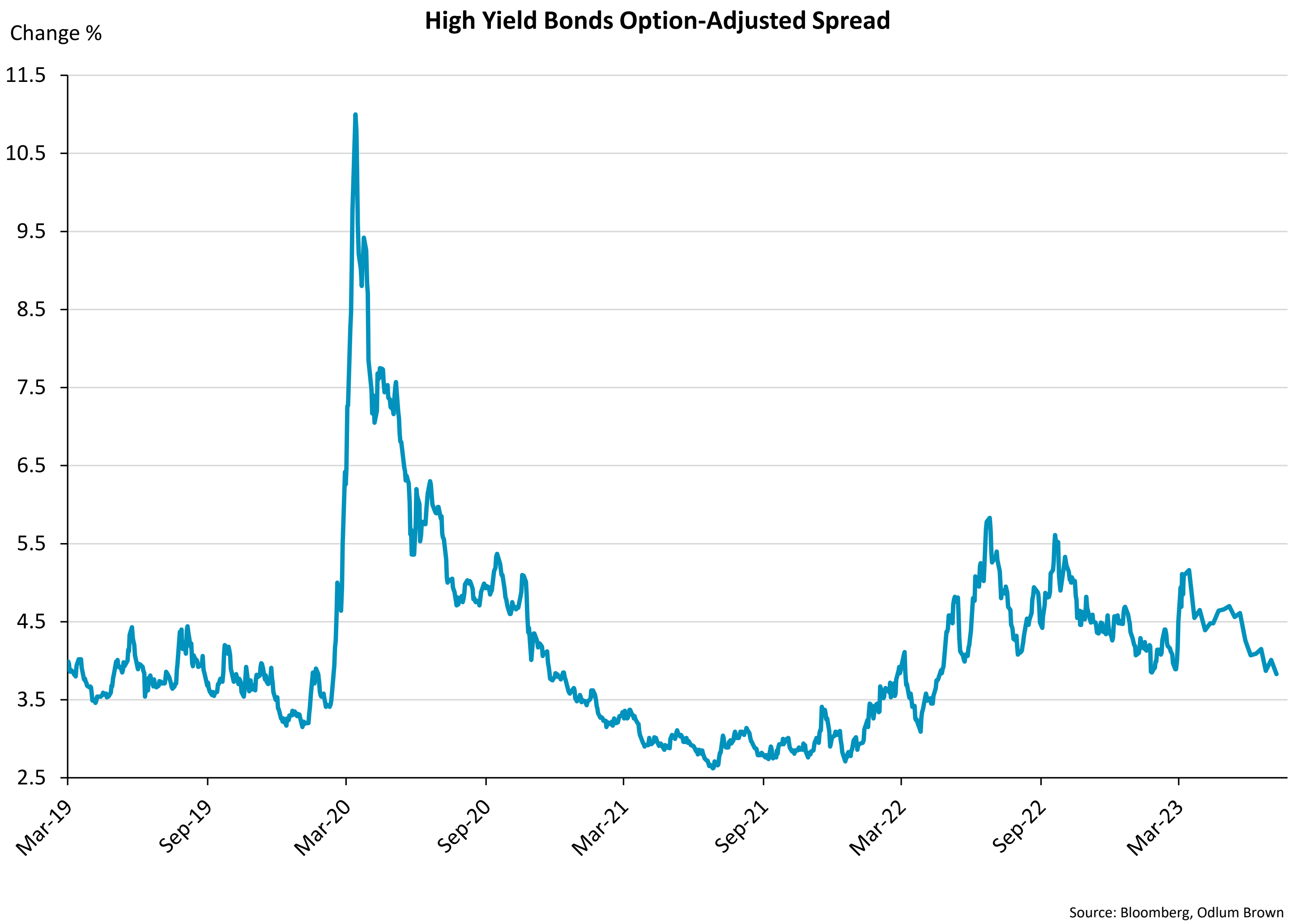
Of note, the Canadian bond market continues to underperform its U.S. counterpart. At two years, the yield spread is negative 10 basis points versus negative 77 basis points in March, while Canadian 10-year yields have narrowed to only 41 basis points. In Canada, the inflation outlook is not promising, and the economy continues to surprise on the upside. This under-performance is likely to continue with parity in yields possible.



After touching 4% for the third time since October, this bellwether bond has moved back to its moving averages. The support level is at 3.25%.



The yield curve remains inverted at record levels for this cycle.



High-yield bond spreads have reached their lows for the past year.

Outlook

Inflation remains the key bond market driver. There has been significant improvement in headline inflation, while the important core rates and the Fed's preferred rate – core PCE – remain stubbornly high. Meanwhile, the employment market, consumer confidence and the housing market are buoyant. This seals the likelihood that the Fed will go ahead with another 25-basis point hike in its Fed Funds rate at the July 26 FOMC meeting.

The key question is whether the tightening phase will end then. To be sure, we are closer to the end of the tightening cycle, but it is premature to expect central banks, most notably the Fed, to consider easing for the balance of the year. It is possible we have seen a double-top in 10-year yields at 4% while short-term yields may be pushed even higher, producing even more inversion in the yield curve. The emergence of a serious credit contraction would materially change this outlook. In the meantime, corporate bond markets, both investment-grade and high-yield, have been well behaved, narrowing meaningfully from Government bond yields. Cracks are showing in the taut labour market, and manufacturing has weakened significantly. However, consumer confidence has improved greatly along with retail sales.

There are few signs of global inflation subsiding sufficiently to allow central banks to contemplate easing monetary policy. For inflation to even reach 3% seems optimistic. Thus, 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 will move higher. However, it is more likely that the 10-year yield will continue to fluctuate in a range centered around 3.75%, with 4.25% a possible high.

Consumer confidence has rallied which flies in the face of recession fears. Fed tightening over the past 16 months is working its way through the system. The market must also deal with the $2.1 trillion dollar budget deficit. Combined with Quantitative Tightening (QT) to the tune of $95 billion per month, this portends higher bond yields. Despite optimism among pundits, there are no signs that the Fed will lower its key interest rate this year. Whenever this tightening cycle ends, the Fed will likely also end its QT program.

The yield curve has inverted further, following the latest FOMC deliberations, with the spread between two- and 10-year Treasurys now at negative 100 basis points. In the meantime, fixed income investors are facing only modest returns for this year after last year’s record negative returns.

Strategy

Inflation is the enemy of bonds and will continue to be a major negative for the foreseeable future. At an inflation rate of 2%, the purchasing power of a $100 10-year bond would fall to $82 by maturity. At an inflation rate of 4%, it would decline to only $68. Thus, defending principal remains paramount. While we may be close to the end of the monetary-tightening cycle, we believe interest rates will remain elevated and possibly rise further during the remainder of the year. Consequently, we recommend maintaining a short-duration, high-quality portfolio.

This approach has proven to be effective in providing income while, importantly, protecting principal value. Is this the time to extend the average term of one’s fixed income portfolio? This is an important question. Year to date, the bond market has produced, as measured by the FTSE Universe Index, a modest 1.57%. Merely investing in a six-month Canadian Treasury bill yielding 5.1% would produce a return of 4% for 2023. A one-year Treasury Bill offers a yield of 5.20%. For a five-year Government of Canada bond to match this return, its yield would have to fall 48 basis points. Similarly, a 10-year bond would have to fall by 26 basis points. These returns are possible, but not probable. Fixed income investors are being paid to wait given current short-term yields, which are holding out the prospect of moving even higher depending on central bank actions.

We continue to advocate the use of floating-rate debentures, whose coupons should remain well above 5% if central banks pause, in combination with a one- to five-year ladder of high-quality corporate and provincial bonds. The net result is a short duration, high-yielding portfolio. We have recommended adding federal and provincial bonds to portfolios due to the distinct possibility of some stress in corporate credit.

This year’s increase in bond yields has caused bonds that were issued at lower yields to trade at deep discounts to their par values. These bonds are attractive for taxable accounts, as the capital gain component of the overall return is taxed at preferential rates. While most of these bonds have rallied, considerable discounts remain. We have created the **Odlum Brown Discount Corporate Ladder** portfolio to take advantage of this opportunity and note there are also a number of Government of Canada bonds that are available at deep discounts as well.

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.