Monthly Fixed Income Update

Hank Cunningham **June 22, 2023**

Interest Rate Summary	May 31-23	Apr 28-23	Mar-31-23	Feb-28-23	Jan-31-23	Dec-30-22	Nov-30-22	Oct-31-22	Sep-29-22
U.S.									
3-Month T-Bill	5.40%	5.06%	4.75%	4.81%	4.67%	4.37%	4.35%	4.07%	3.30%
2-Yr Treasury	4.41%	4.00%	4.03%	4.82%	4.20%	4.43%	4.31%	4.49%	4.28%
10-Yr Treasury	3.65%	3.43%	3.47%	3.92%	3.51%	3.88%	3.61%	4.05%	3.83%
Canada									
3-Month T-Bill	4.64%	4.43%	4.38%	4.50%	4.40%	4.24%	3.99%	3.85%	3.78%
2-Year Canada	4.22%	3.65%	3.73%	4.20%	3.75%	4.05%	3.87%	3.89%	3.79%
10-Year Canada	3.19%	2.84%	2.90%	3.33%	2.91%	3.30%	2.94%	3.25%	3.17%

Performance	YTD*	2022	2021	2020	2019	2018	2017
DEX Universe Bond Index	1.54%	-11.69%	-2.54%	8.68%	6.87%	1.41%	2.52%
DEX Federal Bond Index	0.67%	-9.34%	-2.62%	7.28%	3.73%	2.39%	0.13%
DEX Provincial Bond Index	1.86%	-15.05%	-3.28%	9.86%	9.07%	0.66%	4.33%
DEX All Corporate Index	2.34%	-11.54%	-1.34%	8.74%	8.05%	1.10%	3.38%
DEX “A” Corporate Index	2.38%	-9.87%	-2.30%	8.98%	9.65%	0.51%	4.42%
DEX Real Return Bonds	-1.59%	-14.32%	1.84%	13.02%	8.02%	-0.05%	0.72%
DEX High Yield Bonds	2.38%	-5.44%	6.18%	6.69%	8.48%	2.15%	5.20%

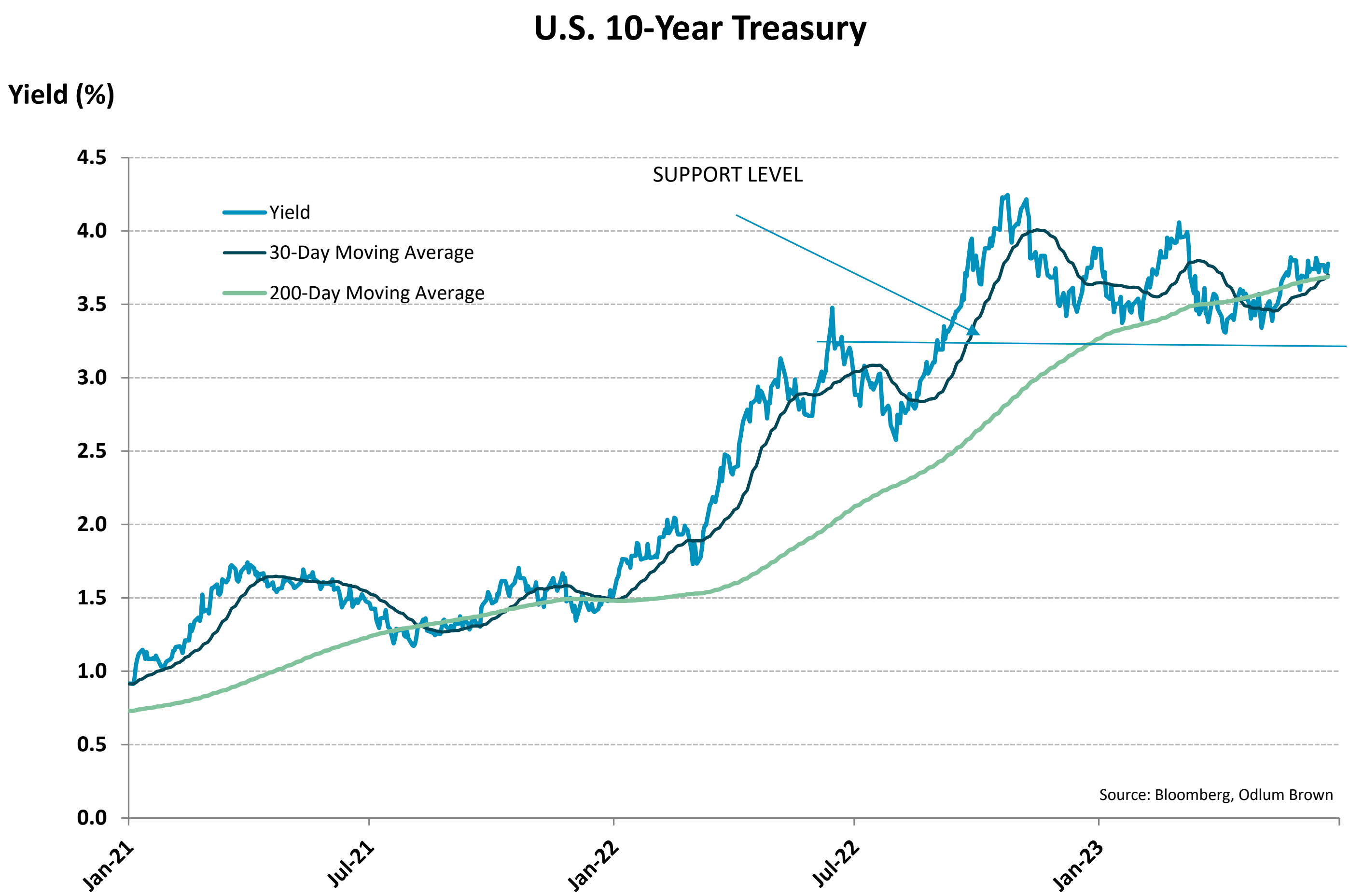
**As of June 21, 2023*

Comments

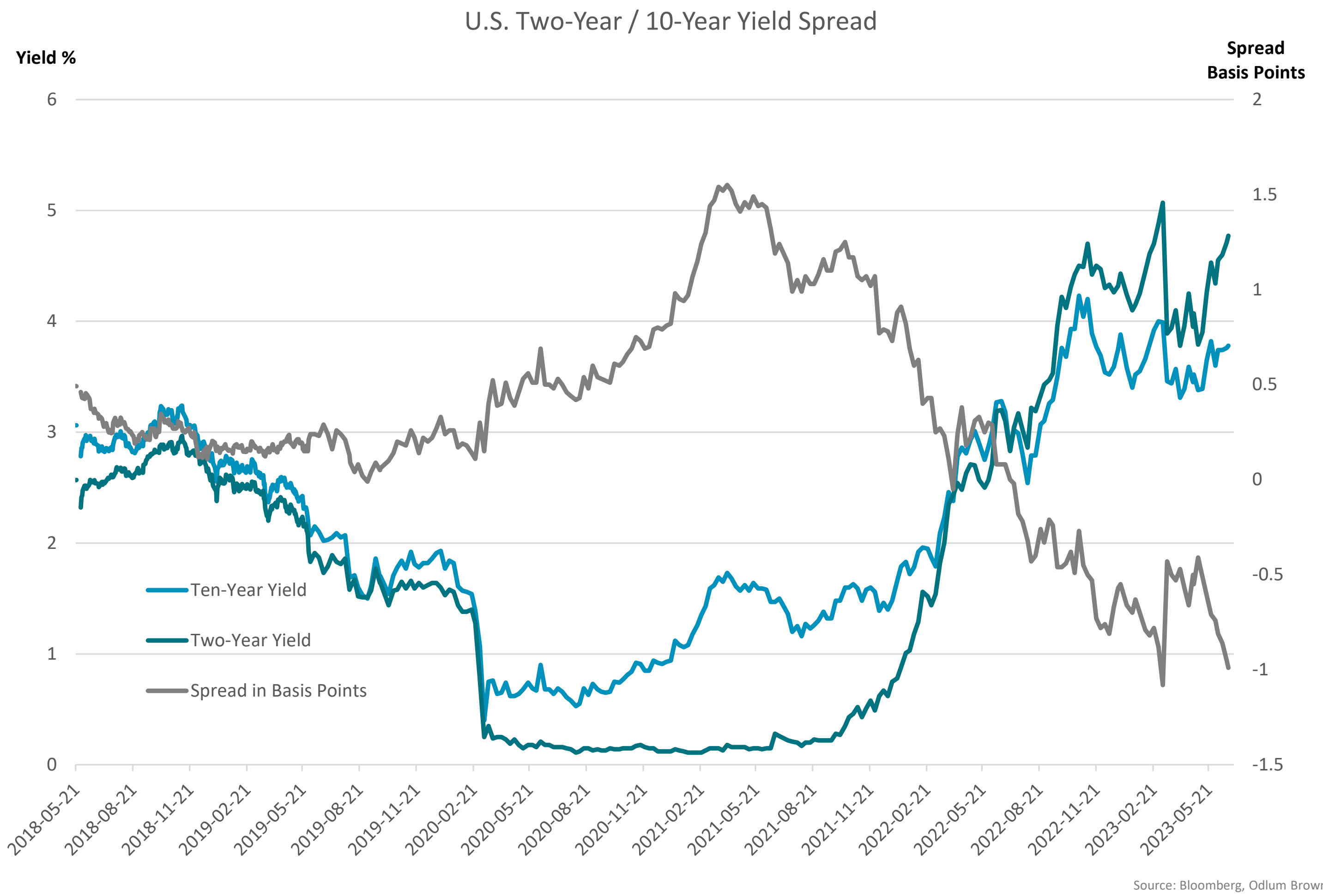
Bond yields trended higher in May and have risen further in June. The bellwether U.S. 10-year rose 20 basis points in May and a further 10 basis points this month and is yielding 3.76%. Corporate bond markets remained stable, with both investment-grade and high-yield bonds registering narrower spreads from U.S. Treasury yields. This was despite increasing chatter about a possible credit crunch emerging.

Meanwhile, there has been further weakness in the U.S. economy but not sufficient enough to cause the Fed to change its stance. It raised the Fed Funds rate by 25 basis points on May 3, the tenth consecutive increase. Then, on June 14, it announced a pause while it looks at new data but signaled the likelihood of two more increases this year. The Bank of Canada, after pausing in March, raised its overnight rate on June 5, reflecting adverse inflation news plus a surprise 3.1% advance in Q1 GDP. The ECB and Australia followed suit. The Bank of England surprised markets with a 50-basis-point hike in its key lending rate.

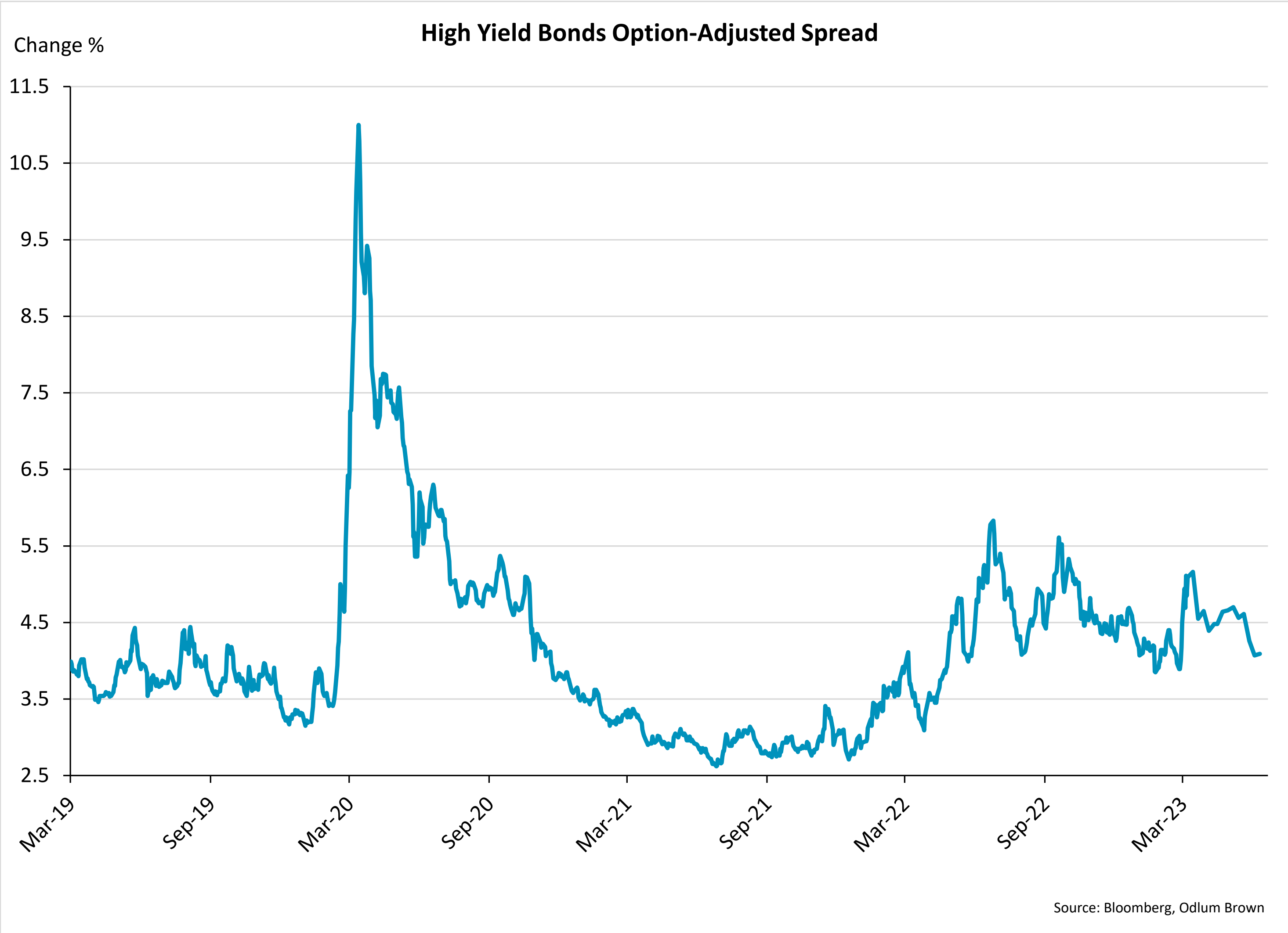
Of note, the Canadian bond market is still underperforming its U.S. counterpart. At two years, the yield spread is negative seven basis points versus negative 77 basis points in March. Meanwhile at 10 years, the yield spread has narrowed to only 40 basis points. Canada's inflation outlook is not promising, and our economy continues to surprise on the upside. This underperformance is likely to endure with parity in yields possible.



This bellwether bond has moved above its moving averages and there is resistance at 4% and 4.25%.



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



High-yield bond spreads, after rising by 100 basis points during the regional bank crisis, have since fallen.

Outlook

Interest rates and bond yields are likely headed higher, despite some deterioration in global growth prospects and moderation in inflation. The IMF is still forecasting positive growth this year. Recession forecasts are growing, and some are concerned about a bout of credit contraction.

Nevertheless, it would be optimistic to think that the U.S. Federal Reserve Board will lower the Fed Funds Rate any time soon. The Fed has paused as it considers the cumulative effects of its tightening to date and will be more keenly attentive to economic data. Chair Powell did say that there is a strong possibility of two more 25-basis-point hikes in the Fed Funds Rate, thus dashing the hopes of those who believed the Fed would lower rates this year.

The possibility of a serious credit contraction would change this outlook materially. In the meantime, corporate bond markets, both investment grade and high yield, have been well behaved, even narrowing in yield from Government bonds. To be sure, cracks are showing in the taut labour market, consumer confidence is ebbing and manufacturing has weakened significantly. However, 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. With two-year and 10-year Treasurys seemingly anchored at 4.75% and 3.75% respectively, there is little room for these bond yields to decline.

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 fluctuate in a range centered around 3.75%, as it has for a while.

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 16 months is working its way through the system and the recent liquidity calamity is evidence that it is straining the U.S. economy. 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 begin to 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 approaching negative 100 basis points. In the meantime, fixed income investors are facing only modest returns this year after last year's record poor performance.

Strategy

Inflation is the enemy of bonds and will continue to be a major problem for the foreseeable future. At 2% inflation, the purchasing power of a $100 10-year bond would fall to $82 by maturity; at 4% inflation, it would decline to only $68. Thus, defending principal is paramount.

While we may be close to the end of the monetary-tightening cycle, we believe interest rates will stay elevated and possibly rise further this year. Consequently, we recommend a short-duration, high-quality portfolio. We also advocate the use of floating-rate debentures, whose coupons should remain 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. Due to the distinct possibility of some stress in corporate credit, we suggest adding federal and provincial bonds to portfolios.

This year's increase in 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 exist. 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 available at deep discounts as well.

We also advise 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.