Monthly Fixed Income Update

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March 27, 2023

Interest Rate Summary	Feb-28-23	Jan-31-23	Dec-30-22	Nov-30-22	Oct-31-22	Sep-29-22	Aug-31-22	Jul-29-22	Jun-30-22
U.S.									
3-Month T-Bill	4.81%	4.67%	4.37%	4.35%	4.07%	3.30%	2.93%	2.36%	1.67%
2-Yr Treasury	4.82%	4.20%	4.43%	4.31%	4.49%	4.28%	3.50%	2.89%	2.96%
10-Yr Treasury	3.92%	3.51%	3.88%	3.61%	4.05%	3.83%	3.20%	2.65%	3.02%
Canada									
3-Month T-Bill	4.50%	4.40%	4.24%	3.99%	3.85%	3.78%	3.23%	2.65%	2.09%
2-Year Canada	4.20%	3.75%	4.05%	3.87%	3.89%	3.79%	3.65%	2.96%	3.09%
10-Year Canada	3.33%	2.91%	3.30%	2.94%	3.25%	3.17%	3.12%	2.61%	3.22%

Performance	YTD*	2022	2021	2020	2019	2018	2017
DEX Universe Bond Index	4.30%	-11.69%	-2.54%	8.68%	6.87%	1.41%	2.52%
DEX Federal Bond Index	4.01%	-9.34%	-2.62%	7.28%	3.73%	2.39%	0.13%
DEX Provincial Bond Index	5.13%	-15.05%	-3.28%	9.86%	9.07%	0.66%	4.33%
DEX All Corporate Index	3.57%	-11.54%	-1.34%	8.74%	8.05%	1.10%	3.38%
DEX "A" Corporate Index	3.57%	-9.87%	-2.30%	8.98%	9.65%	0.51%	4.42%
DEX Real Return Bonds	1.25%	-14.32%	1.84%	13.02%	8.02%	-0.05%	0.72%
DEX High Yield Bonds	1.91%	-5.44%	6.18%	6.69%	8.48%	2.15%	5.20%

**As of March 24, 2023*

Comments

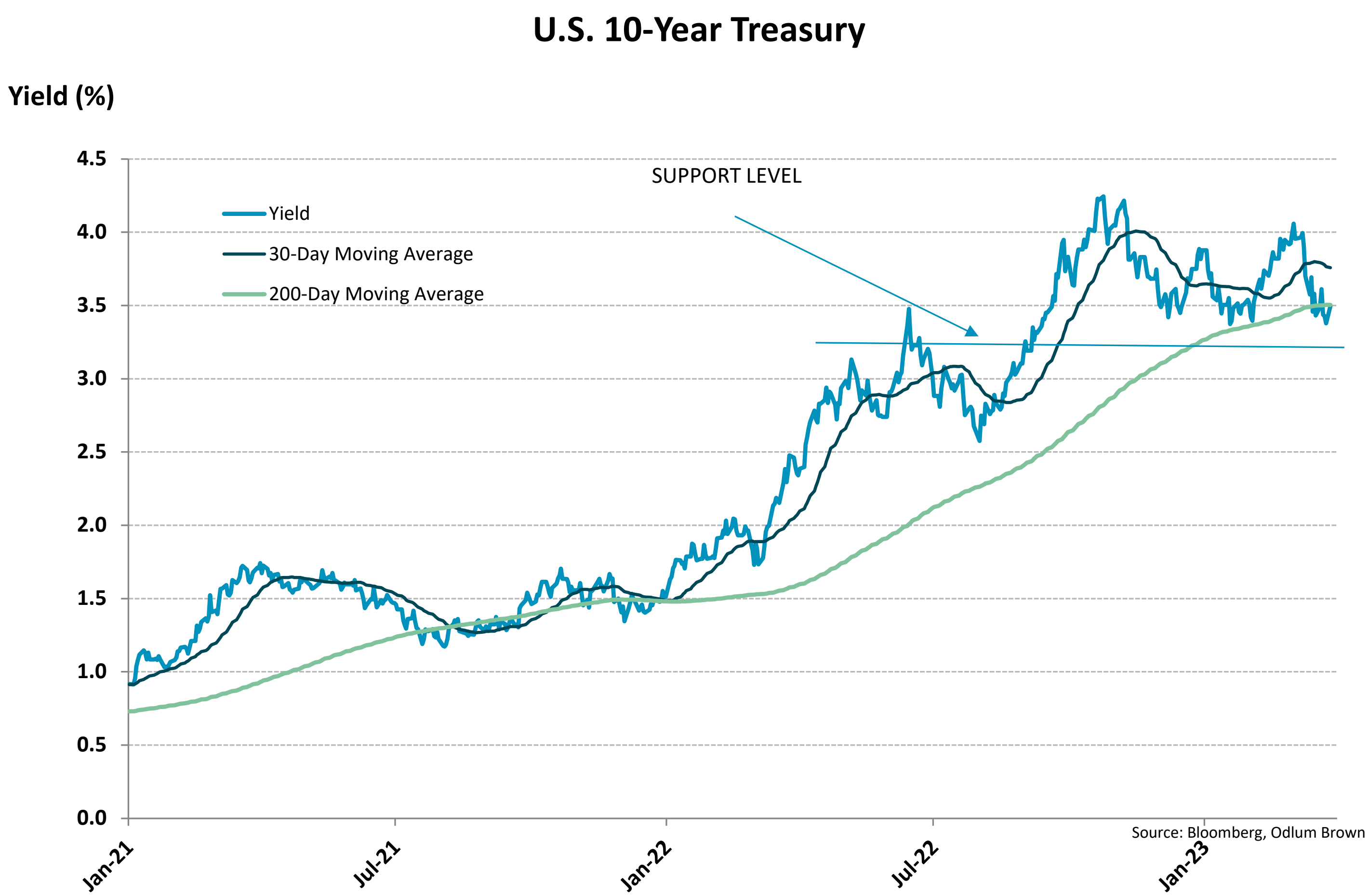
Despite a strong start to the year, February saw a resurgence of inflation fears. The year-to-date performance noted above demonstrates a flight to quality as government bonds meaningfully outperformed corporate bonds. Real return and high yield bonds lagged. Economic data was surprisingly resilient and employment data was strong. Inflation did not melt away as witnessed in wholesale and retail inflation as well as accelerating wage increases. The Fed's favourite gauge – Core PCE – also came in significantly hotter than consensus estimates.

Thus, yields climbed to the end of the month and kept on rising, reaching 5% and 4% respectively for the two-year and 10-year U.S. Treasury. Corporate bond spreads remained well behaved with no credit stress visible. However, issuance of new corporate bonds, both investment-grade and high yield, ground to a temporary halt.

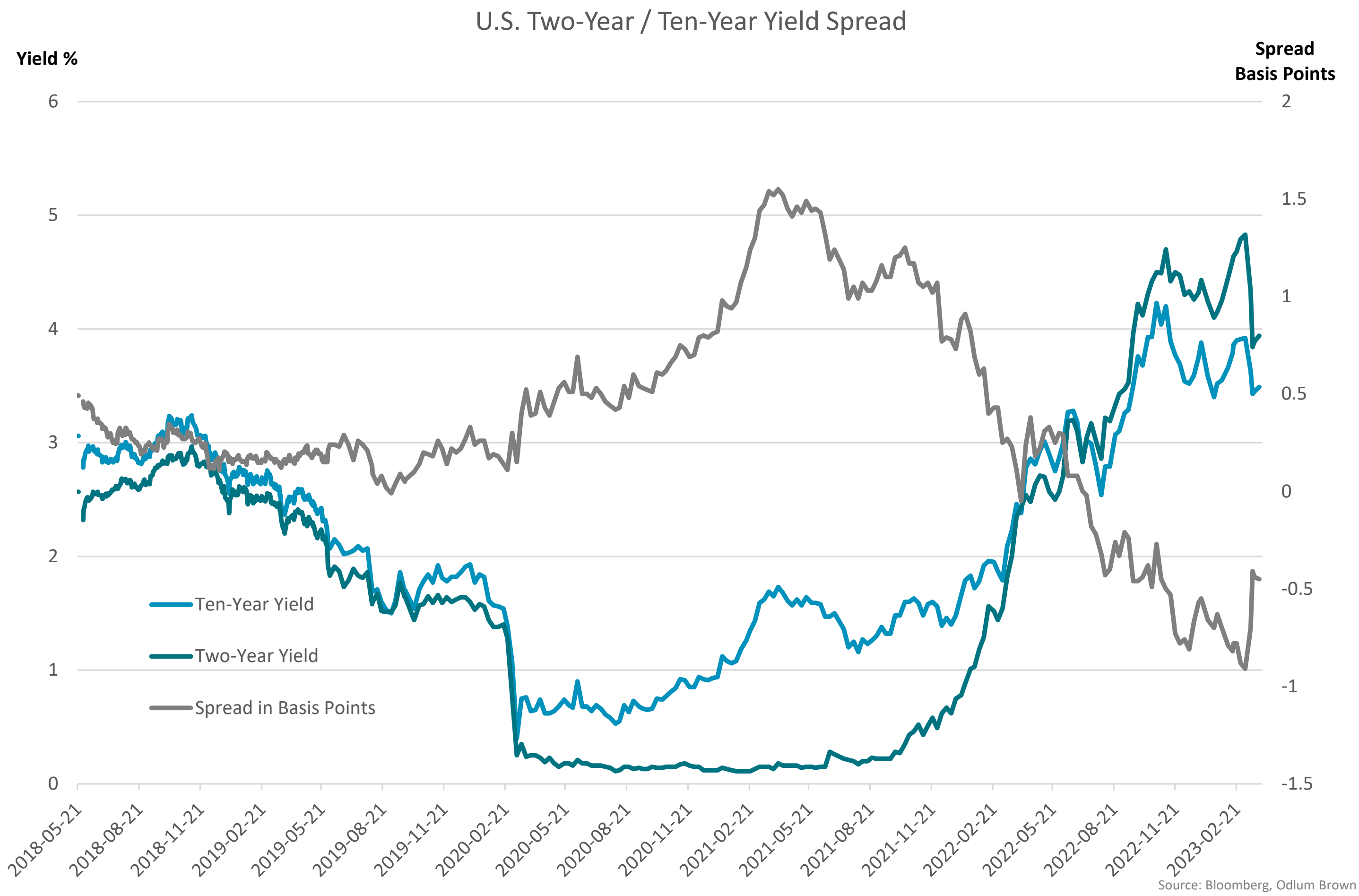
On March 8, Fed Chair Powell gave a particularly hawkish speech, leaving little doubt that the Fed was not done raising rates. On March 22, the Fed raised its rate a further 25 basis points and left the door open for at least one more such increase.

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.

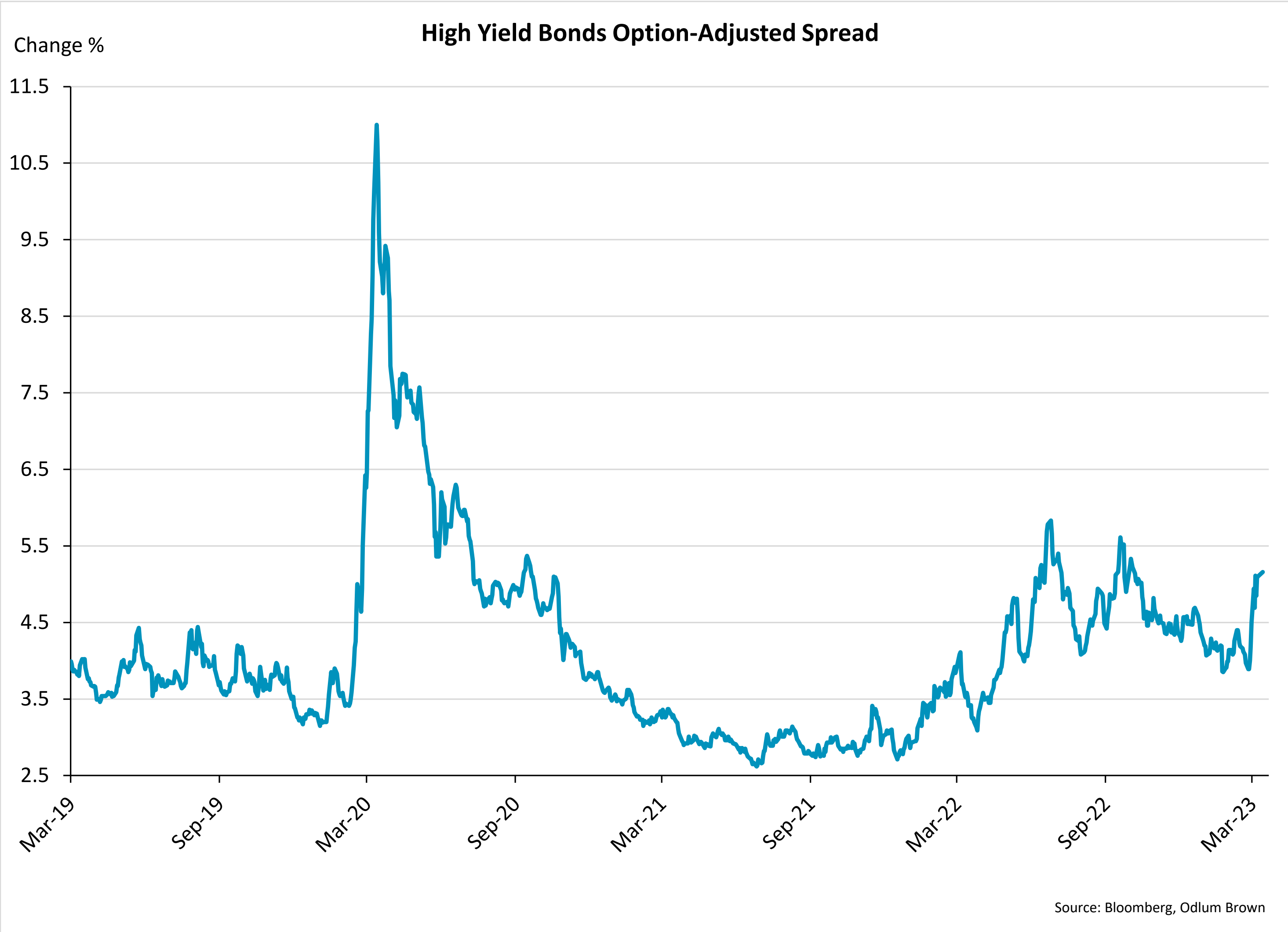
Then, the investment world changed. A crisis of liquidity in the U.S. banking system and accompanying responses from various institutions led to dramatic swings in bond yields at all maturities. The two-year Treasury note fell to 3.80% and the 10-year slumped to 3.4%. These were not straight-line moves as emotions ebbed and flowed. Fundamentals were not affected through these tumultuous gyrations. This was an event driven by liquidity shortages and bank failures. While credit conditions remained solid, the yield spread on high yield bonds over Treasurys widened by 100 basis points. Investment-grade corporate bonds were less affected.



This bellwether bond recently exceeded 4% for the second time before plummeting as the liquidity crisis unfolded. After coming close to the 3.25% support level, it has bounced to 3.50%.



The yield curve inversion lessened significantly as two-year yields plummeted by more than 10-year yields.



High yield bonds, after being well behaved over the past year, rose in yield by 100 basis points due to recent liqiuidity strains.

Outlook

Global growth prospects have improved, with the IMF forecasting a growth rate of 2.6%. 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.

Consumer confidence has been dealt a huge blow, which may contribute to a meaningful near-term contraction in economic activity. 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 liquidity crisis 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 economic data exceeding estimates and inflation still high, central banks may continue to tighten.

The yield curve will stay inverted for a while, but it has flattened meaningfully in the past week. In the meantime, fixed income investors can earn 2-4% 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 bounced back up to 3.50%.

Strategy

Inflation is the enemy of bonds and will continue 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 if central banks pause, in combination with a one- to five-year ladder, of high-quality corporate and provincial bonds. We have long advocated high-quality bonds in fixed income portfolios. This remains the case and with a distinct possibility of some stress developing in corporate credit, 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.

Please read our Odlum Brown Limited Disclaimer and Disclosure - It is important!