Monthly Fixed Income Update

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Interest Rate Summary	Feb-29-24	Jan-31-24	Dec-29-23	Nov-30-23	Oct 31-23	Sep 29-23	Aug 31-23	Jul 31-23	Jun 30-23
U.S.									
3-Month T-Bill	5.38%	5.37%	5.34%	5.39%	5.47%	5.45%	5.45%	5.42%	5.30%
2-Yr Treasury	4.62%	4.21%	4.25%	4.68%	5.09%	5.05%	4.87%	4.88%	4.90%
10-Yr Treasury	4.25%	3.91%	3.88%	4.33%	4.93%	4.57%	4.11%	3.96%	3.84%
Canada									
3-Month T-Bill	4.96%	5.00%	5.04%	5.02%	5.02%	5.11%	5.12%	5.04%	4.91%
2-Year Canada	4.18%	3.97%	3.89%	4.19%	4.64%	4.87%	4.64%	4.67%	4.58%
10-Year Canada	3.49%	3.32%	3.11%	3.55%	4.06%	4.02%	3.56%	3.50%	3.27%

Performance	YTD*	2023	2022	2021	2020	2019	2018
DEX Universe Bond Index	-0.33%	6.69%	-11.69%	-2.54%	8.68%	6.87%	1.41%
DEX Federal Bond Index	-0.77%	5.00%	-9.34%	-2.62%	7.28%	3.73%	2.39%
DEX Provincial Bond Index	-2.38%	7.31%	-15.05%	-3.28%	9.86%	9.07%	0.66%
DEX All Corporate Index	-0.21%	8.37%	-11.54%	-1.34%	8.74%	8.05%	1.10%
DEX "A" Corporate Index	-0.43%	8.23%	-9.87%	-2.30%	8.98%	9.65%	0.51%
DEX Real Return Bonds	-2.73%	1.99%	-14.32%	1.84%	13.02%	8.02%	-0.05%
DEX High Yield Bonds	2.24%	10.00%	-5.44%	6.18%	6.69%	8.48%	2.15%

*As of March 13, 2024

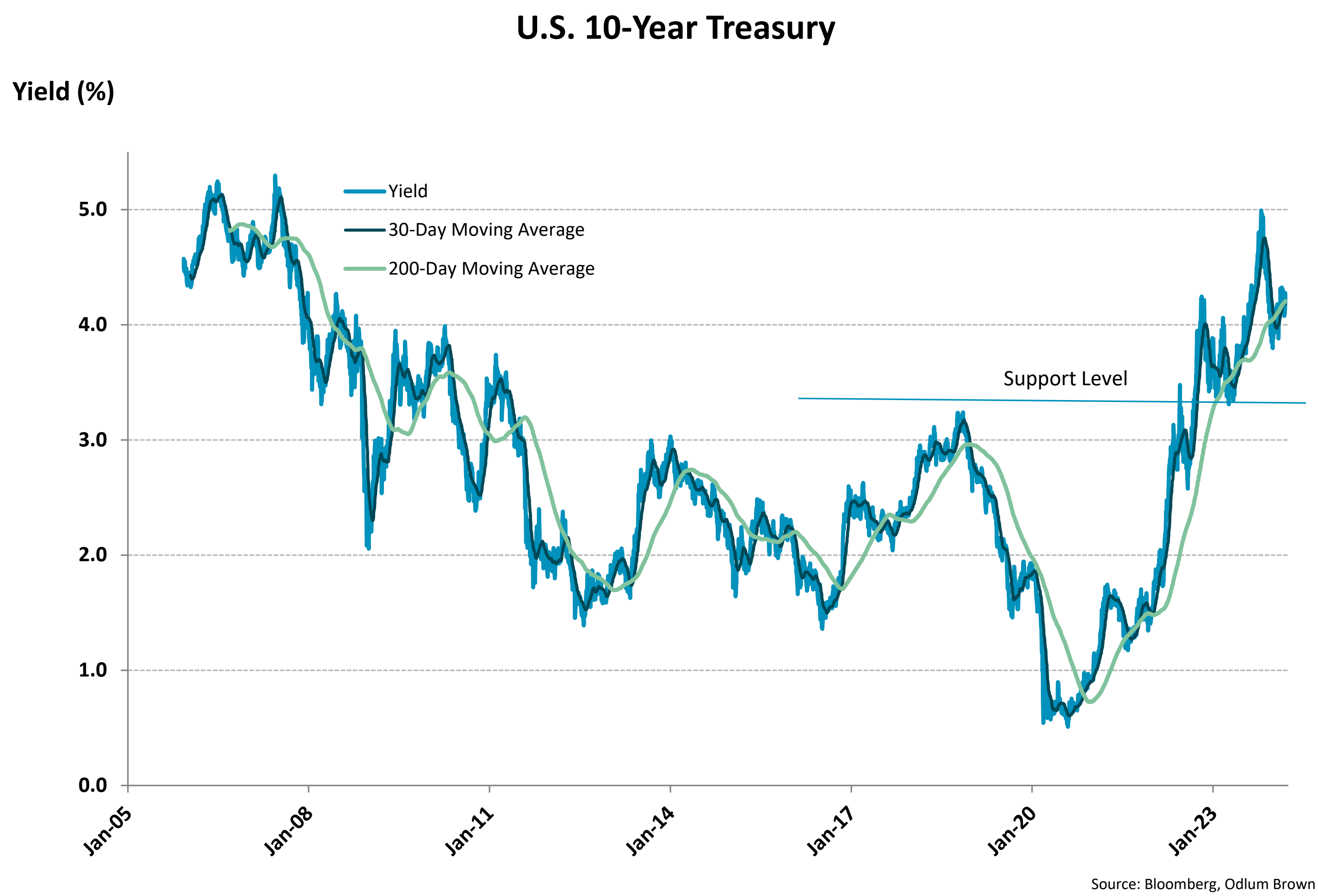
Comments

After the dramatic year-end rally in the bond market (and decline in yields), bond yields have generally increased this year. For example, the yield on the 10-year U.S. Treasury bond was 4.25% at the end of February, a meaningful increase from 3.88% at year end. The most recent inflation report once again demonstrated the stickiness of bond yields, further underscoring the need for the Federal Reserve to be patient before reducing its Federal Funds Rate.

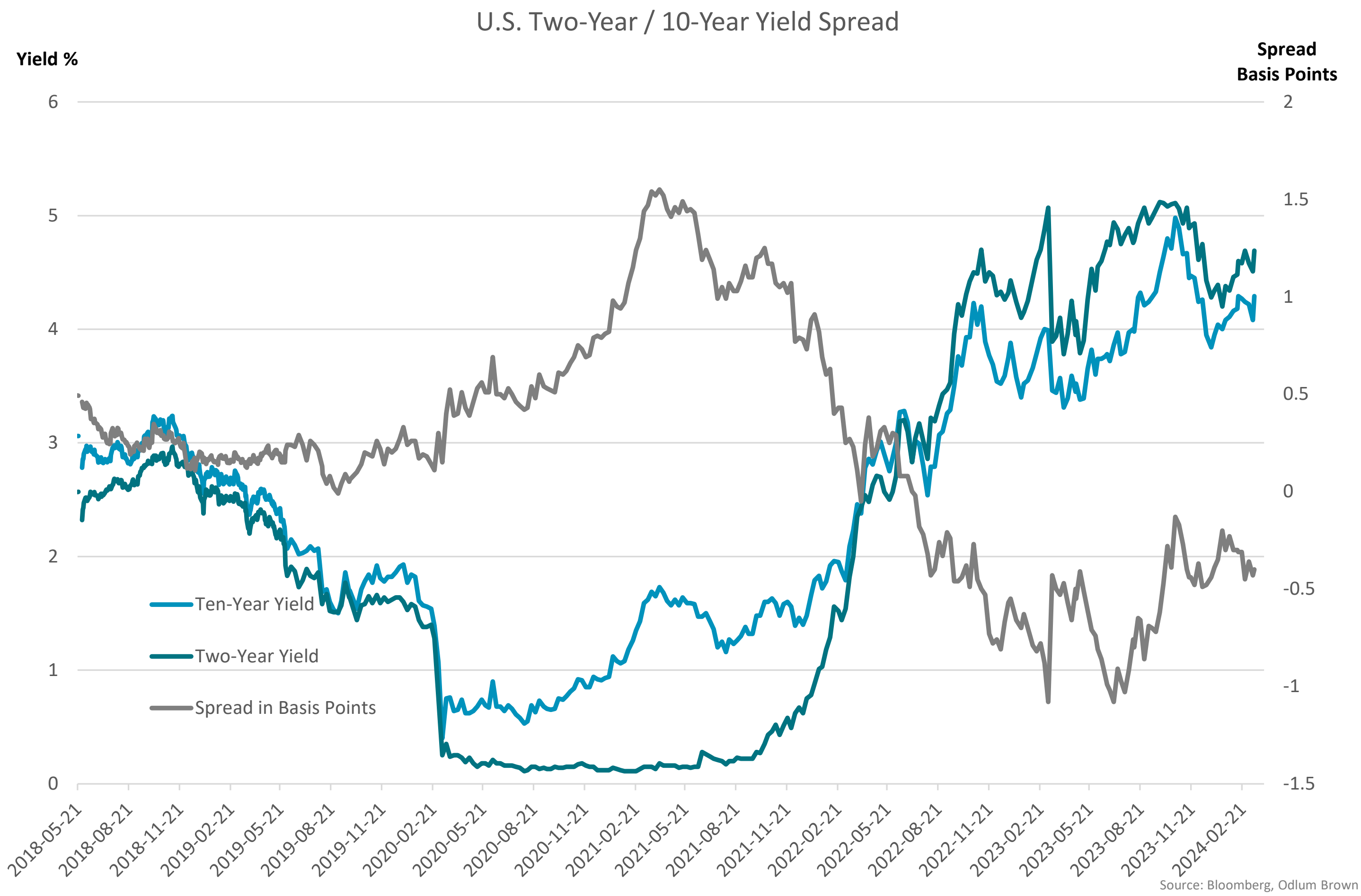
In fact, the Federal Reserve Open Market Committee voted to leave the Fed Funds Rate unchanged at its January meetings. Fed Chair Powell made it clear that the Fed is in no hurry to lower rates, effectively dashing hopes for a March rate reduction. Since then, a string of fresh economic data has underscored the resilience in the economy, making the case more difficult for further easing of inflationary pressures. This was borne out by the recent two CPI releases in the U.S. and a wholesale inflation statement, displaying an uptick in all categories. In addition, the latest employment report also displayed strength, although the unemployment rate edged higher. Consumer sentiment also showed some improvement.

Canada reported weaker inflation, with our core rate falling to 3.6%. This led to immediate speculation of an early rate reduction by the Bank of Canada. However, on March 6, the Bank of Canada stated that it remains wary of inflation trends after further signs that the economy was firming.

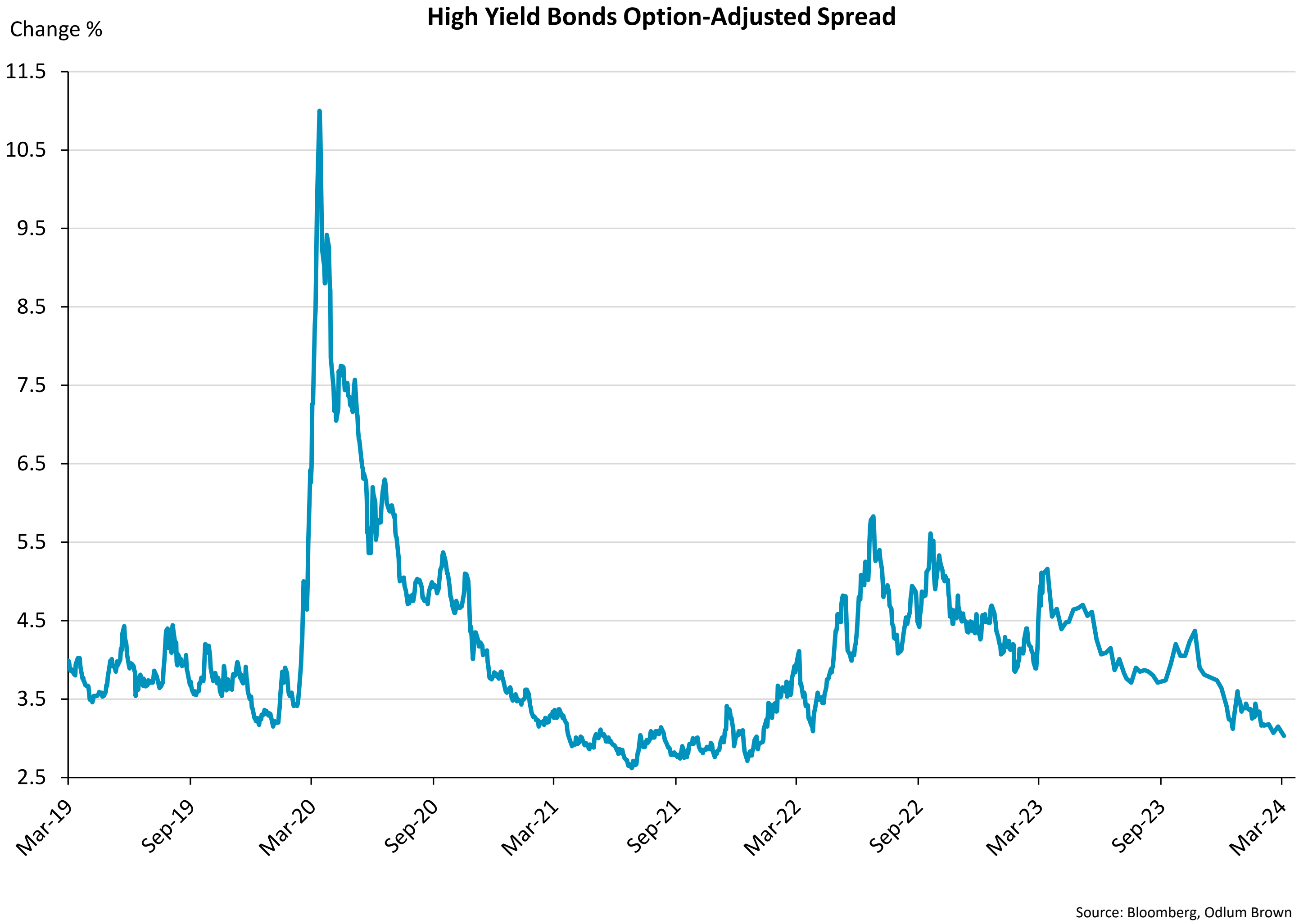
The corporate bond market, both for investment grade and high yield, has been active as treasurers have taken advantage of attractively narrow yield spreads from government bonds. The U.S. Government bond market has thus far absorbed the extremely large auctions with relative ease with only one or two weak results.



After reaching a 16-year high of 5%, this bond plunged to 3.88% but has since soared well above its 200-day moving average to 4.25%.



The yield curve remains stubbornly inverted but well below peak inversion.



High yield bond spreads are at new lows for the past year.

Outlook

Economists are preoccupied with what kind of “landing” the U.S. economy will experience: will it be hard, soft or nonexistent? Too much time has been spent forecasting the next recession. Meanwhile, the economy, seemingly ignoring the Fed’s monetary stance, is growing at a 3% pace.

There will be no change in the monetary stance in the U.S. or Canada in the near term. While the Fed has stated that three rate reductions are possible this year, the timing of those has been pushed out. The recent CPI reports underscore inflation’s tenacity, meaning a rate reduction could be counterproductive to the Fed’s fight. What is more probable is a gradual move to lower rates with the Fed Funds rate possibly moving 50 to 75 basis points lower towards the end of the year.

A similar scenario is unfolding in Canada after GDP growth picked up towards the end of 2023, putting the Bank of Canada on the sidelines, and reiterating its cautious stance at its recent deliberations.

Another important factor is the increasing likelihood that the Bank of Japan will tighten its monetary policy and that could lead Japanese investors to sell their U.S. Treasury bonds.

Inflation remains the key fundamental for the bond market outlook. With the recent economic strength, accompanied by escalating wages, it will likely prove difficult for inflation to reach the avowed 2% target level. Should that prove to be the case, then it stands to reason that longer-term bond yields should rise from current levels. This also reflects the massive borrowing requirements as there is no attempt to rein in federal deficits. In addition, the Federal Reserve is still engaged in quantitative tightening (QT). The Bank of Canada is also continuing its QT. The net effect ultimately will be an eventual return to a positive yield curve, with short- and mid-term yields likely falling below longer-term yields. Still, the normalization of the yield curve probably won’t happen until the latter part of the year.

Strategy

Last month we concluded that it might be timely to extend duration in fixed income portfolios. After the somewhat hawkish comments by the Federal Reserve on January 31, followed by two surprisingly bearish CPI reports, we no longer recommend any significant extension in duration. Fixed income investors should favour one- to three-year maturities with an overall duration of three years. We continue to favour the maintenance of existing one- to five-year ladders. The above advice pertains to the investment of new monies. Given the tight spreads between corporate and government yields, we favour government bonds, especially provincial issues. The after-tax appeal for discount government and corporate bonds remains attractive.

A one- to five-year ladder of high-quality corporate and provincial bonds provides a short-duration, high-yielding portfolio. We have recommended adding federal and provincial bonds to portfolios to enhance liquidity and credit quality in the event of stress appearing in corporate credit.

This year’s increase in yields has caused bonds issued at lower yields to trade at deep discounts to their par values. These have proved to be attractive for taxable accounts, as the capital gains 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 several Government of Canada bonds available at deep discounts as well.

We also recommend using the **Odlum Brown Corporate Bond Ladder**, which features more current coupon bonds. The **Odlum Brown Model Portfolio** is well positioned for this environment with 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.