Monthly Fixed Income Update

Hank Cunningham **May 16, 2023**

Interest Rate Summary	Apr 28-23	Mar-31-23	Feb-28-23	Jan-31-23	Dec-30-22	Nov-30-22	Oct-31-22	Sep-29-22	Aug-31-22
U.S.									
3-Month T-Bill	5.06%	4.75%	4.81%	4.67%	4.37%	4.35%	4.07%	3.30%	2.93%
2-Yr Treasury	4.00%	4.03%	4.82%	4.20%	4.43%	4.31%	4.49%	4.28%	3.50%
10-Yr Treasury	3.43%	3.47%	3.92%	3.51%	3.88%	3.61%	4.05%	3.83%	3.20%
Canada									
3-Month T-Bill	4.43%	4.38%	4.50%	4.40%	4.24%	3.99%	3.85%	3.78%	3.23%
2-Year Canada	3.65%	3.73%	4.20%	3.75%	4.05%	3.87%	3.89%	3.79%	3.65%
10-Year Canada	2.84%	2.90%	3.33%	2.91%	3.30%	2.94%	3.25%	3.17%	3.12%

Performance	YTD*	2022	2021	2020	2019	2018	2017
DEX Universe Bond Index	3.65%	-11.69%	-2.54%	8.68%	6.87%	1.41%	2.52%
DEX Federal Bond Index	3.03%	-9.34%	-2.62%	7.28%	3.73%	2.39%	0.13%
DEX Provincial Bond Index	4.22%	-15.05%	-3.28%	9.86%	9.07%	0.66%	4.33%
DEX All Corporate Index	3.74%	-11.54%	-1.34%	8.74%	8.05%	1.10%	3.38%
DEX “A” Corporate Index	3.75%	-9.87%	-2.30%	8.98%	9.65%	0.51%	4.42%
DEX Real Return Bonds	0.71%	-14.32%	1.84%	13.02%	8.02%	-0.05%	0.72%
DEX High Yield Bonds	2.43%	-5.44%	6.18%	6.69%	8.48%	2.15%	5.20%

**As of May 15, 2023*

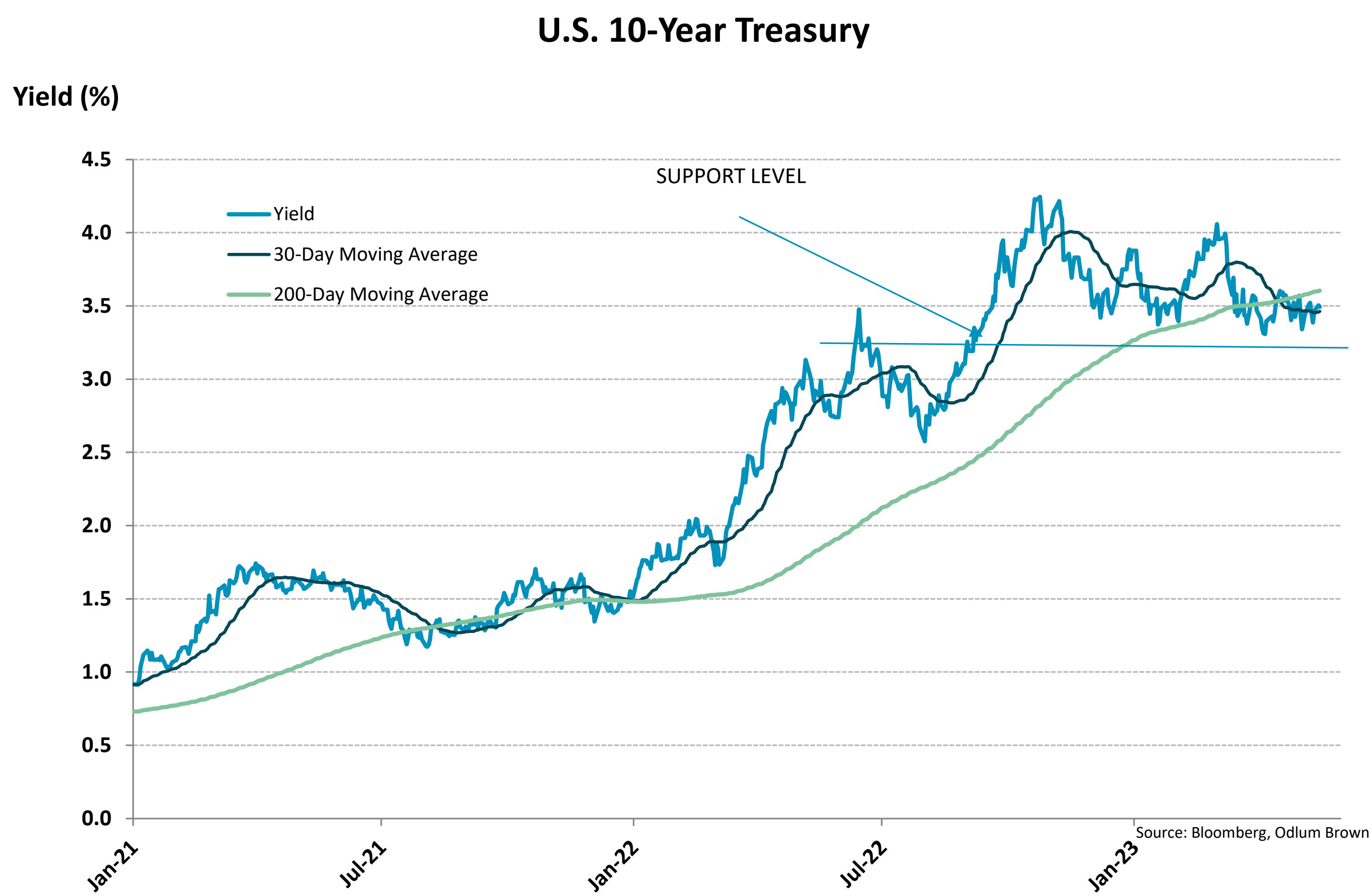
Comments

After months of wide and wild gyrations, bond yields in April traded in a much narrower range of 30 basis points, reaching a high of 3.60% and a low of 3.31% before ending the month at 3.43%. This trend to calmer markets has continued thus far into May.

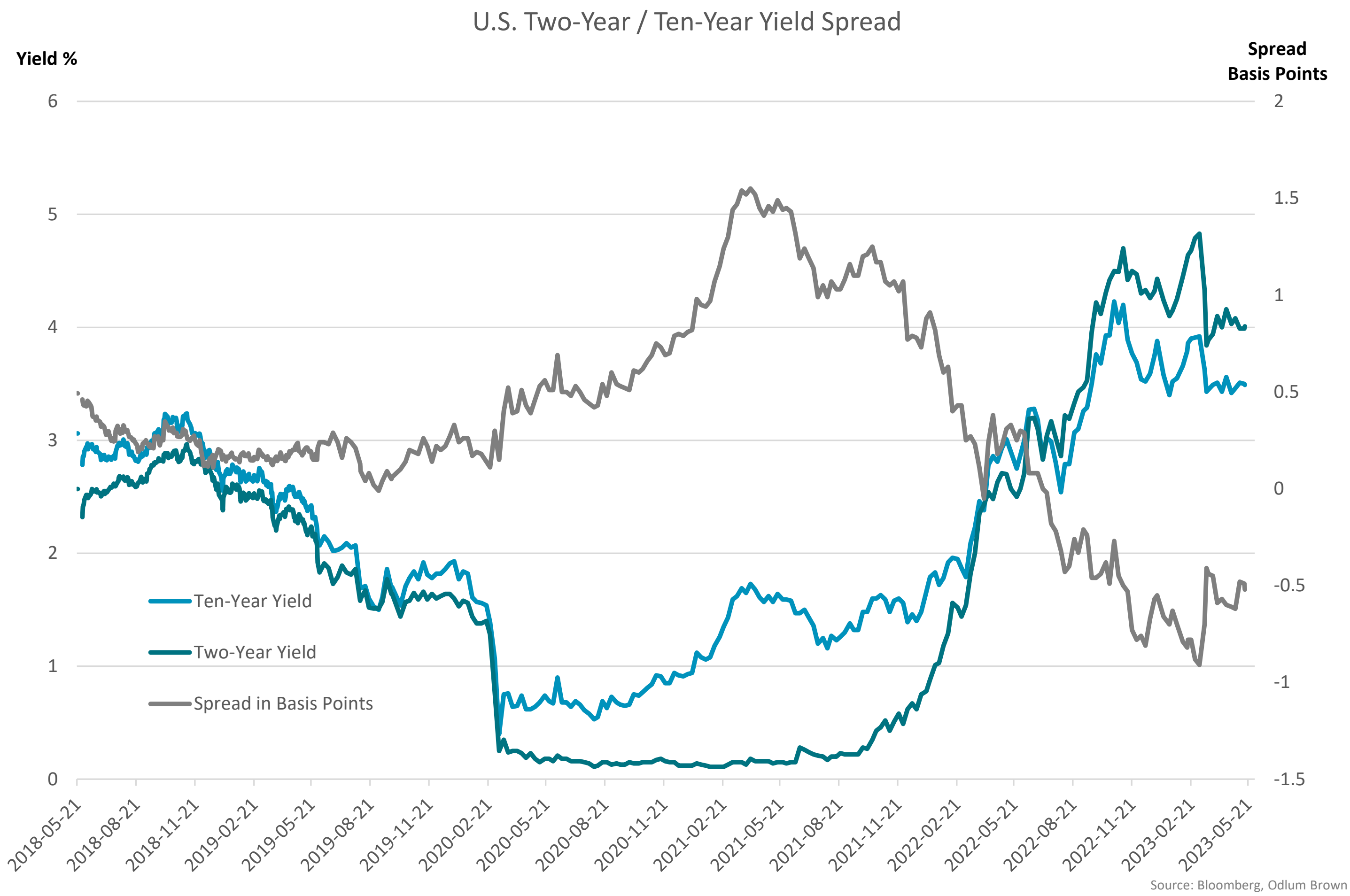
The strife in the regional banking sector has subsided somewhat but remains a near-term threat. Meanwhile, there has been further weakness in the economy but not sufficient enough to cause the Fed to change its stance. It raised the Fed Funds rate by 25 basis points on May 3, its tenth consecutive increase. On this occasion, Chair Powell hinted at the possibility of a pause. Subsequent news from the labour market and from the Consumer Price report left little doubt that the Fed would at least hold tight.

Corporate bond markets remained stable, registering only minor widening in yields spreads from Treasury bonds. This was despite increasing chatter about a possible credit crunch emerging. As to Canada, the Bank of Canada again left its overnight rate unchanged; this stance was supported by weak housing starts, soft retail sales and weak GDP growth.

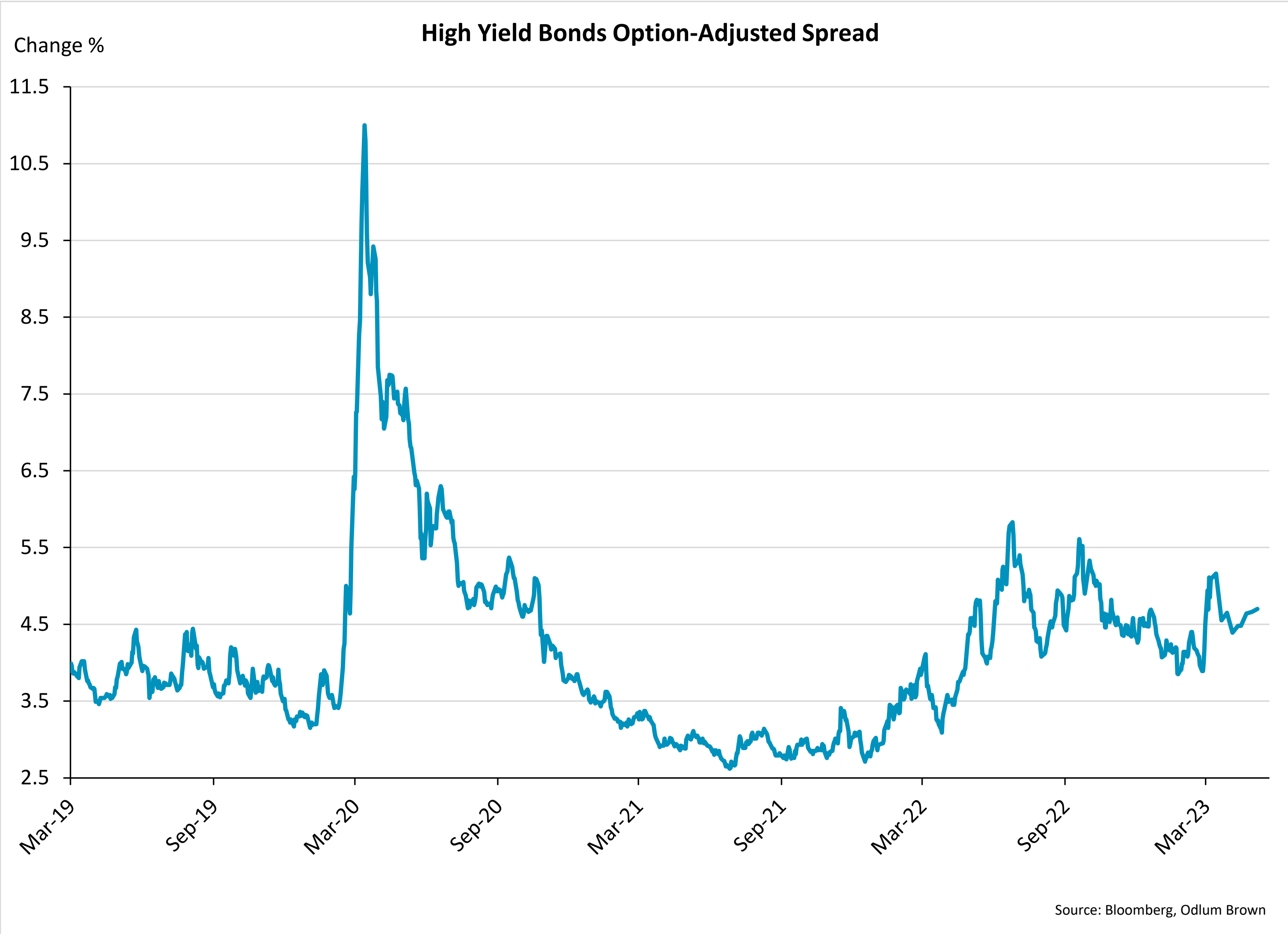
Internationally, the ECB raised its key lending rate by 25 basis points, signaling there would be further such increases. Inflation remains a persistent issue in Europe.



This bellwether bond is at a critical juncture as its yield has converged with its moving averages.



The yield curve remains inverted but at lower spreads than before the regional bank crisis.



High yield bonds, after rising 100 basis points during the regional bank crisis, have been relatively well behaved.

Outlook

Global growth prospects have deteriorated, with the IMF downgrading its outlook but still with a positive estimate. In light of recent developments in the banking industry, the global economy will be fragile. Recession forecasts are growing, and some are concerned about a possible bout of credit contraction.

Nevertheless, it would be naïve to think that the U.S. Federal Reserve will lower the Fed Funds Rate any time soon. The Fed may pause, as it considers the cumulative effects of the tightening to date, and it will be more keenly attentive to economic data. However, the fallout from the regional banking crisis is causing a credit contraction, which, if it accelerates, could cause economic activity to slow more rapidly than current consensus. At minimum, the Fed would have to pause here. At worst, it may have to relax its monetary tightness and begin lowering rates. To be sure, there are cracks showing in the taut labour market, consumer confidence is ebbing and manufacturing has weakened significantly.

On a global scale, there are few signs of inflation subsiding sufficiently to allow central banks to contemplate easing monetary policy. For inflation to 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 could move back up. However, it is more likely that the 10-year yield will continue to fluctuate in a range centered around 3.50%.

Consumer confidence has been dealt a huge blow, which may contribute to a meaningful near-term contraction in economic activity. Already, retail sales have declined markedly. 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 passes, and it will, market participants will re-focus on inflation, the economy and the Federal Reserve.

The yield curve will stay inverted for a while, but it has normalized meaningfully of late. With two-year and 10-year Treasurys seemingly anchored at 4% and 3.5% respectively, there is little room for these bond yields to decline. In the meantime, fixed income investors, having already earned a 3.65% average return thus far this year, can look forward to an additional 2% to 3% return for the balance of the year. A typical one- to five-year ladder offers a yield to maturity of almost 5% and has a short duration of just over two years.

Strategy

Inflation is the enemy of bonds and will continue to be a major negative for the foreseeable future. Defending principal remains paramount. We continue to 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 continue to advocate high-quality bonds in fixed income portfolios. There is a distinct possibility of some stress developing in corporate credit, and so we also recommend adding federal and provincial bonds to portfolios.

This year's increase in corporate yields has resulted in a host of bonds, previously issued at lower yields, to trade 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 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.