Monthly Fixed Income Update

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November 17, 2023

Interest Rate Summary	Oct 31-23	Sep 29-23	Aug 31-23	Jul 31-23	Jun 30-23	May 31-23	Apr 28-23	Mar-31-23	Feb-28-23
U.S.									
3-Month T-Bill	5.47%	5.45%	5.45%	5.42%	5.30%	5.40%	5.06%	4.75%	4.81%
2-Yr Treasury	5.09%	5.05%	4.87%	4.88%	4.90%	4.41%	4.00%	4.03%	4.82%
10-Yr Treasury	4.93%	4.57%	4.11%	3.96%	3.84%	3.65%	3.43%	3.47%	3.92%
Canada									
3-Month T-Bill	5.02%	5.11%	5.12%	5.04%	4.91%	4.64%	4.43%	4.38%	4.50%
2-Year Canada	4.64%	4.87%	4.64%	4.67%	4.58%	4.22%	3.65%	3.73%	4.20%
10-Year Canada	4.06%	4.02%	3.56%	3.50%	3.27%	3.19%	2.84%	2.90%	3.33%

Performance	YTD*	2022	2021	2020	2019	2018	2017
DEX Universe Bond Index	1.63%	-11.69%	-2.54%	8.68%	6.87%	1.41%	2.52%
DEX Federal Bond Index	0.94%	-9.34%	-2.62%	7.28%	3.73%	2.39%	0.13%
DEX Provincial Bond Index	1.04%	-15.05%	-3.28%	9.86%	9.07%	0.66%	4.33%
DEX All Corporate Index	3.40%	-11.54%	-1.34%	8.74%	8.05%	1.10%	3.38%
DEX "A" Corporate Index	3.33%	-9.87%	-2.30%	8.98%	9.65%	0.51%	4.42%
DEX Real Return Bonds	-3.45%	-14.32%	1.84%	13.02%	8.02%	-0.05%	0.72%
DEX High Yield Bonds	5.35%	-5.44%	6.18%	6.69%	8.48%	2.15%	5.20%

**As of November 16, 2023*

Comments

Bond yields rose sharply in September and continued to climb in October. The U.S. 10-year Treasury yield rose 46 basis points in September and tacked on a further 36 basis points in October. Thus far in November, this bond has fallen to 4.50%, risen again to 4.65% before tumbling to 4.45% after a tame inflation report.

Price and yield volatility continue to be elevated as market participants go back and forth on whether the Fed is finished tightening, and when it will begin to lower its key overnight rate. To be sure, there are lots of signs that the U.S. economy is slowing, in particular, in the heretofore resilient labour market plus weakening consumer confidence and poor retail sales. Manufacturing has also weakened.

There were several factors contributing to the rising yields in September and October: Fitch's downgrade of U.S. sovereign debt; a U.S. Treasury borrowing program of $1 trillion for the current quarter; a move towards monetary tightening by the Bank of Japan; several strong economic releases; and the revision of U.S. Q1 GDP up to 2.4% from 1.8%.

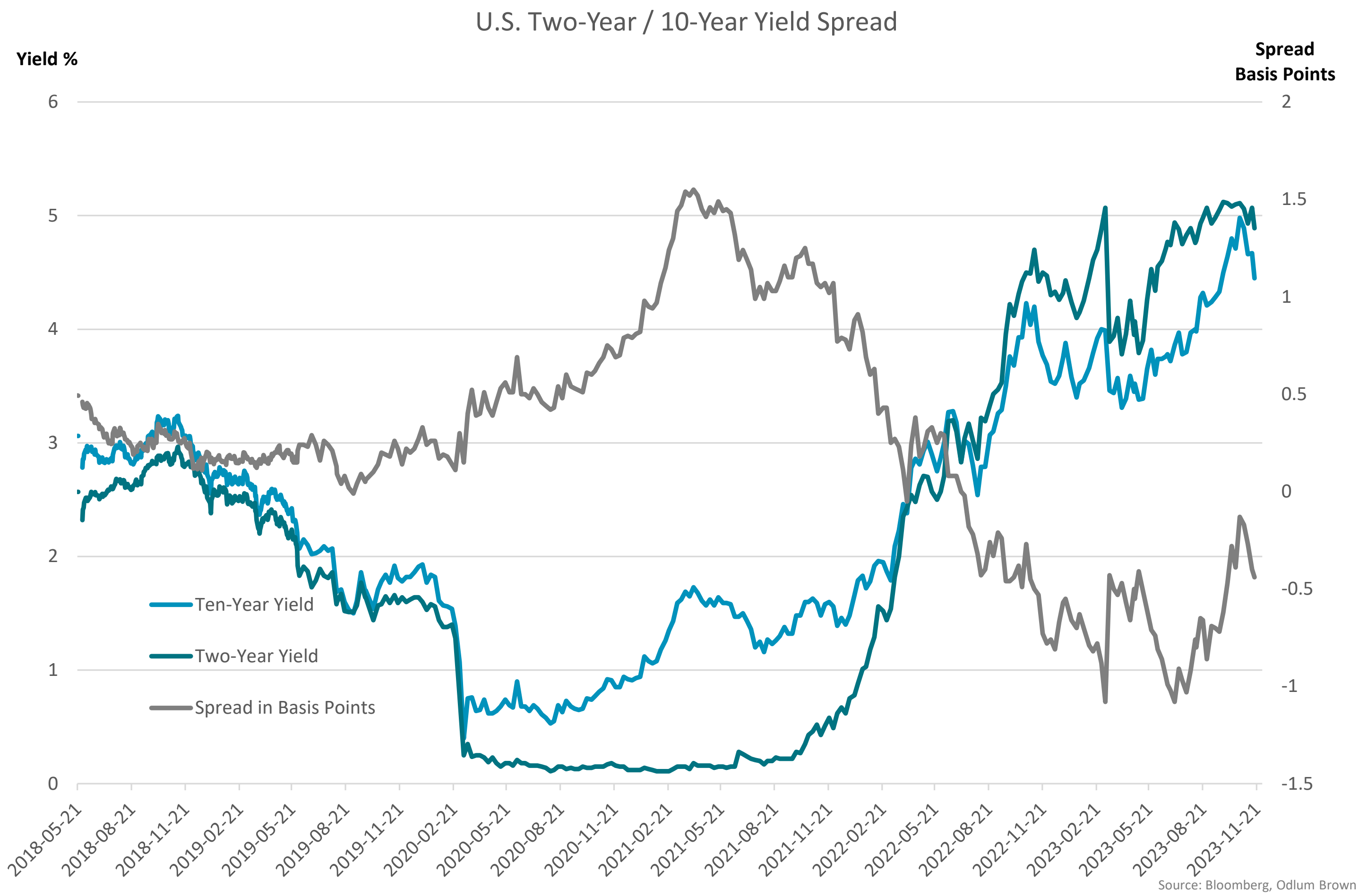
However, after peaking at 5%, 10-year U.S. yield has tumbled this month. At the heart of this decline was another pause by the Federal Reserve and other major central banks, plus a CPI print displaying improvement across the board. This has left the year-over-year core rate at 4%. This is the third consecutive inflation report displaying declines.

Closer to home, the Bank of Canada paused in the wake of clear evidence of stalled economic growth. Canadian yields declined substantially, widening the negative spread from U.S. government securities.

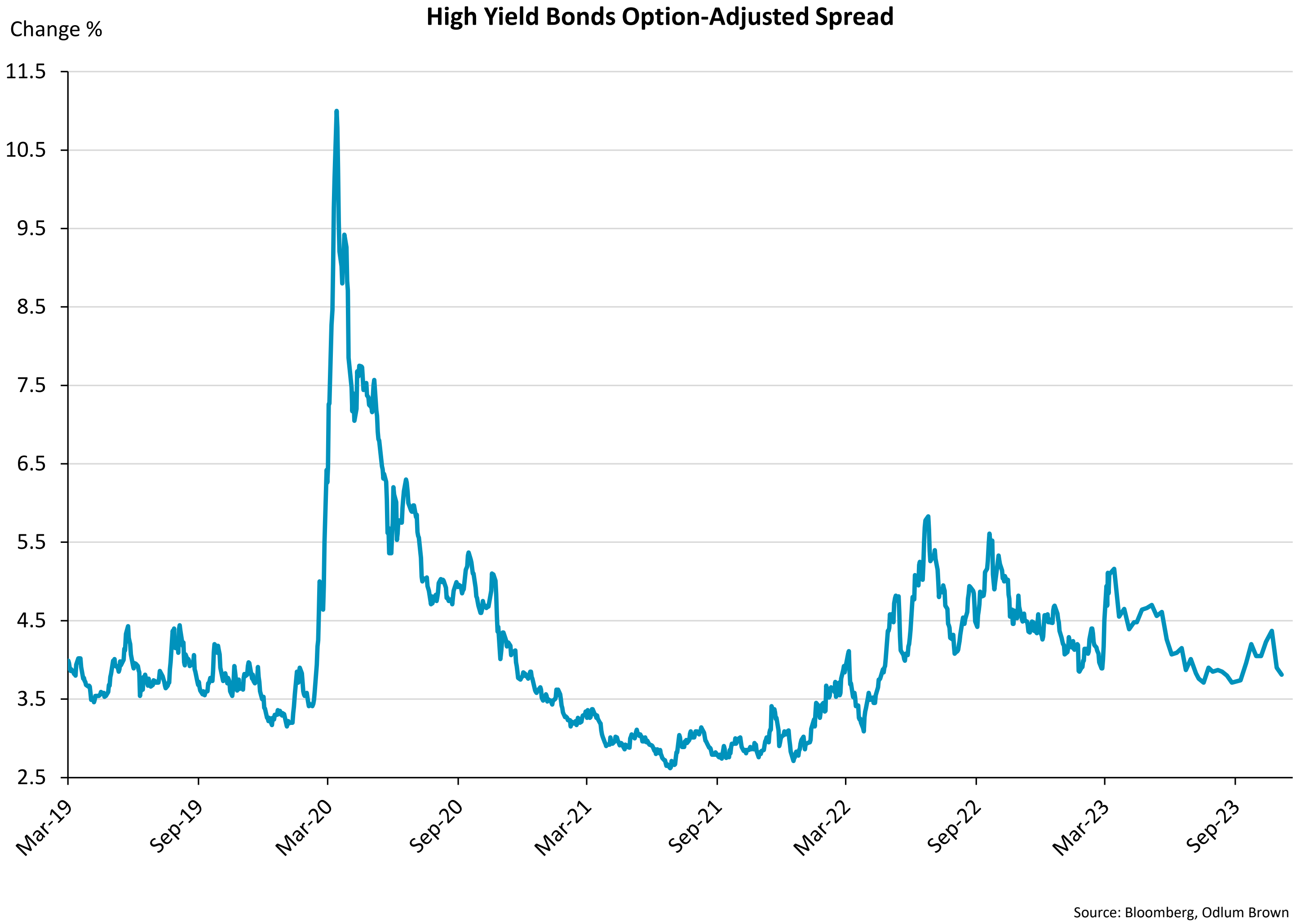
As to the corporate bond market, yields remain relatively tight to government bonds with little evidence of credit problems.

U.S. 10-Year Treasury

After reaching a 16-year high of 5%, this bond has fallen to 4.45%



The yield curve remains inverted. Of note is that the inversion moved close to zero before deepening again.



High yield bond spreads remain near their lows for the past year.

Source: Bloomberg, Odlum Brown

It has taken several years but real yields have now surpassed 2%. They are tracking nominal yields at present.

Outlook

Inflation remains at the forefront of factors influencing bond yields and while it has receded from its worst levels, it has largely halted its downward progress. Inflation expectations remain in the 3% area. The CPI print on November 14 showed continued improvement but the year-over-year core number is still at 4.00%. Following this print and, in addition to the Fed pause, bonds rallied, pushing the bellwether U.S. 10-year note to 4.45% from 5.00%. Speculation that the Fed would soon begin to lower its Funds rate permeated the market. For its part, the Federal Reserve's rhetoric throws cold water on this optimism, stating that the inflation fight is far from finished. The Bank of Canada had similar comments.

However, the factors that contributed to the increase in yields before the recent rally are likely to prevent market yields from retracing further. Such factors include the still-resilient economy, although it shows clear signs of slowing, the $2.3 trillion annual borrowing requirement by the U.S. Government, and the Bank of Japan's move to allow their 10-year bonds to move another 50 basis points higher, towards 1%. This may cause Japanese investors to repatriate some of their foreign holdings, thereby putting upward pressure on bond yields. They own more than $1 trillion worth of U.S. Treasuries.

Also of importance, the recent decline in the inflation rate, combined with the rise in interest rates and bond yields, has produced something not seen in years – positive real yields! The Fed Funds Rate at 5.5%, is now decidedly punitive. Investors can earn a pre-tax real yield and borrowers are incurring a real cost of funds. Inflation expectations have not demonstrated any significant downward movement.

This latest short, sharp rally in the bond market will likely be similar to previous rallies in that it went too far, too fast. The yield curve is still inverted, with two-year yields some 40 basis points higher than 10-year yields. A hot topic in the bond market has become the term: "risk premium" or "term premium." Simply put, it is common sense that, to invest in a long-term bond, investors should be rewarded with a premium over short-term yields and over inflation. This is not the case right now, which leads to the conclusion that, if/when short-term yields fall, long-term yields may not follow, and could actually rise. Thus, we conclude that yields will not end the year much different than where they are presently. The U.S. 10-year could trade in a range from 4.25% to 5%.

Fixed income investors have earned meager returns this year. As measured by the FTSE Bond Universe Index, year-to-date returns are barely over 1%. Corporate bonds have returned close to 3%. For the remainder of the year, fixed income investors will likely realize positive, but modest returns.

Strategy

Inflation remains the chief enemy of the bond market and bond market returns. While we may be close to the end of the monetary-tightening cycle, we believe interest rates will remain elevated for the remainder of the year. The Fed and the Bank of Canada will not ease monetary policy anytime soon. 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? It is an important question. We believe the answer is yes for the Canadian bond market as the Canadian economy has hit stall speed and the Bank of Canada's pause will continue despite its hawkish rhetoric. Fixed income investors should consider moving further out the yield curve, to a maximum term of five years with a duration of two to 2.5 years.

We continue to advocate the use of floating-rate debentures, whose coupons should remain well above 5% even 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 to enhance liquidity and credit quality in the event of some 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 bonds are 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 a number of 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 market 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.