MONTHLY FIXED INCOME UPDATE

Hank Cunningham **September 18, 2023**

Interest Rate Summary	Aug 31-23	Jul 31-23	Jun 30-23	May 31-23	Apr 28-23	Mar-31-23	Feb-28-23	Jan-31-23	Dec-30-22
U.S.									
3-Month T-Bill	5.45%	5.42%	5.30%	5.40%	5.06%	4.75%	4.81%	4.67%	4.37%
2-Yr Treasury	4.87%	4.88%	4.90%	4.41%	4.00%	4.03%	4.82%	4.20%	4.43%
10-Yr Treasury	4.11%	3.96%	3.84%	3.65%	3.43%	3.47%	3.92%	3.51%	3.88%
Canada									
3-Month T-Bill	5.12%	5.04%	4.91%	4.64%	4.43%	4.38%	4.50%	4.40%	4.24%
2-Year Canada	4.64%	4.67%	4.58%	4.22%	3.65%	3.73%	4.20%	3.75%	4.05%
10-Year Canada	3.56%	3.50%	3.27%	3.19%	2.84%	2.90%	3.33%	2.91%	3.30%

Performance	YTD*	2022	2021	2020	2019	2018	2017
DEX Universe Bond Index	0.18%	-11.69%	-2.54%	8.68%	6.87%	1.41%	2.52%
DEX Federal Bond Index	-0.38%	-9.34%	-2.62%	7.28%	3.73%	2.39%	0.13%
DEX Provincial Bond Index	-0.43%	-15.05%	-3.28%	9.86%	9.07%	0.66%	4.33%
DEX All Corporate Index	1.79%	-11.54%	-1.34%	8.74%	8.05%	1.10%	3.38%
DEX "A" Corporate Index	1.71%	-9.87%	-2.30%	8.98%	9.65%	0.51%	4.42%
DEX Real Return Bonds	-5.76%	-14.32%	1.84%	13.02%	8.02%	-0.05%	0.72%
DEX High Yield Bonds	4.06%	-5.44%	6.18%	6.69%	8.48%	2.15%	5.20%

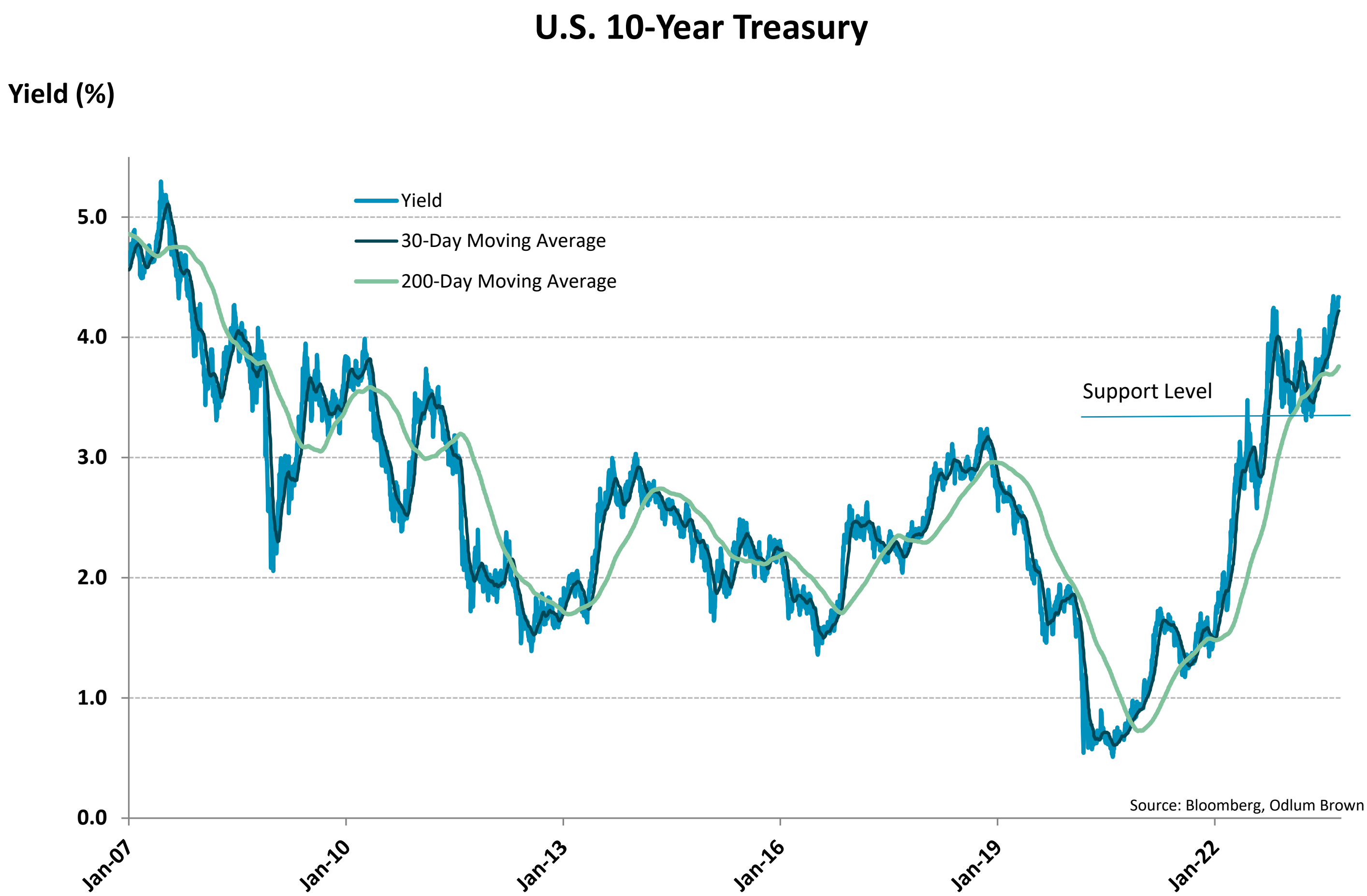
**As of September 15, 2023*

Comments

Short-term interest rates and bond yields rose in August and have moved higher thus far in September. Market yields, measured by the U.S. 10-year note, rose a modest 15 basis points in July and reached a high of 4.34% on August 21. After dipping to 4.11% at month-end, they have moved back up above 4.30%.

There were several factors contributing to these rising yields: 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, including the important employment numbers, with two strong ADP reports plus buoyant housing prints and a pickup in manufacturing activity; and the revision of U.S. Q1 GDP up to 2.4% from 1.8%.

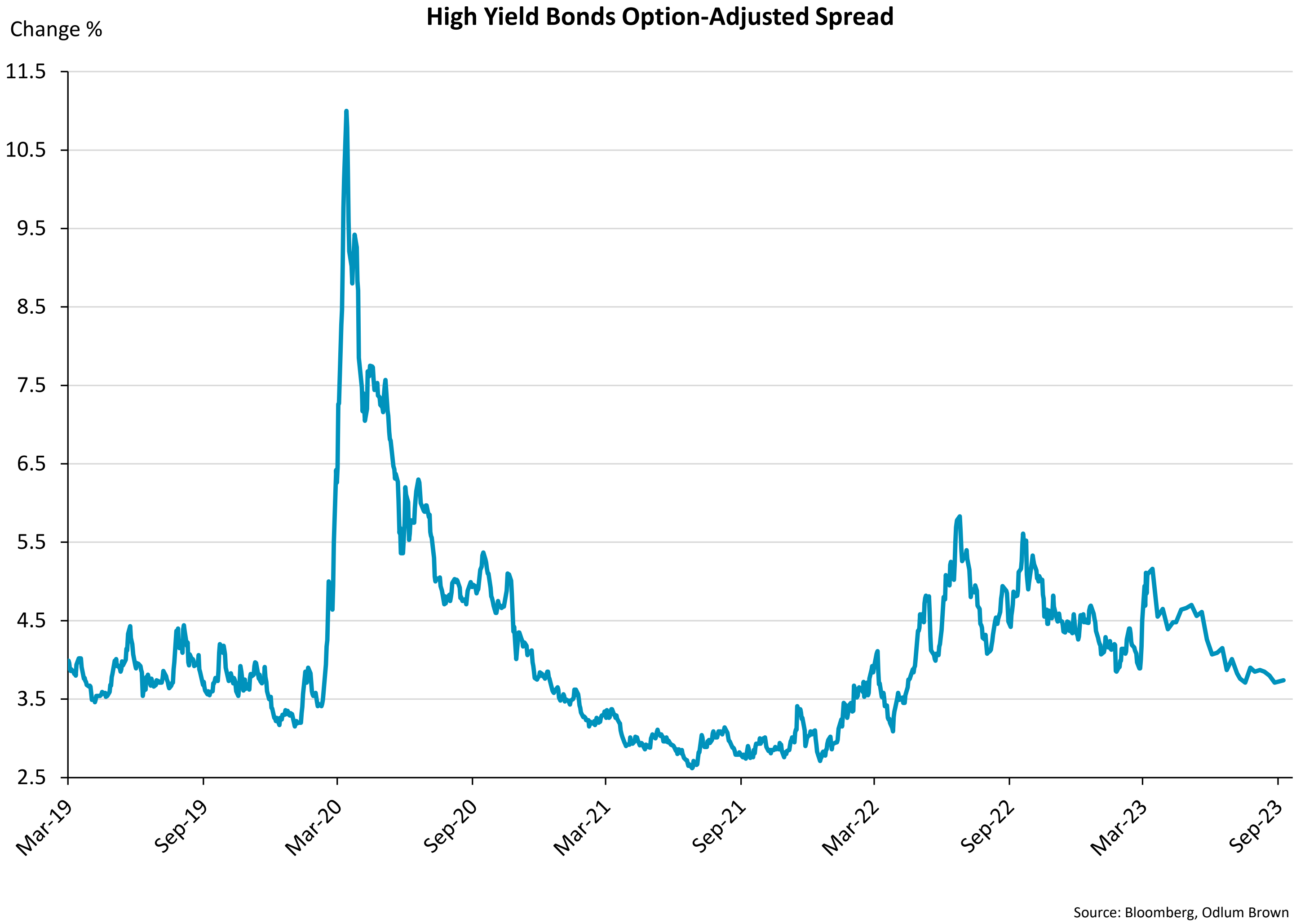
All of this occurred against a backdrop of improving inflation. The U.S. experienced back-to-back modest CPI releases, with the headline rate just over 3% while the year-over-year core rate finally showed some improvement, moving lower to 4.3%. Recession forecasts have been downgraded in the wake of all this news.



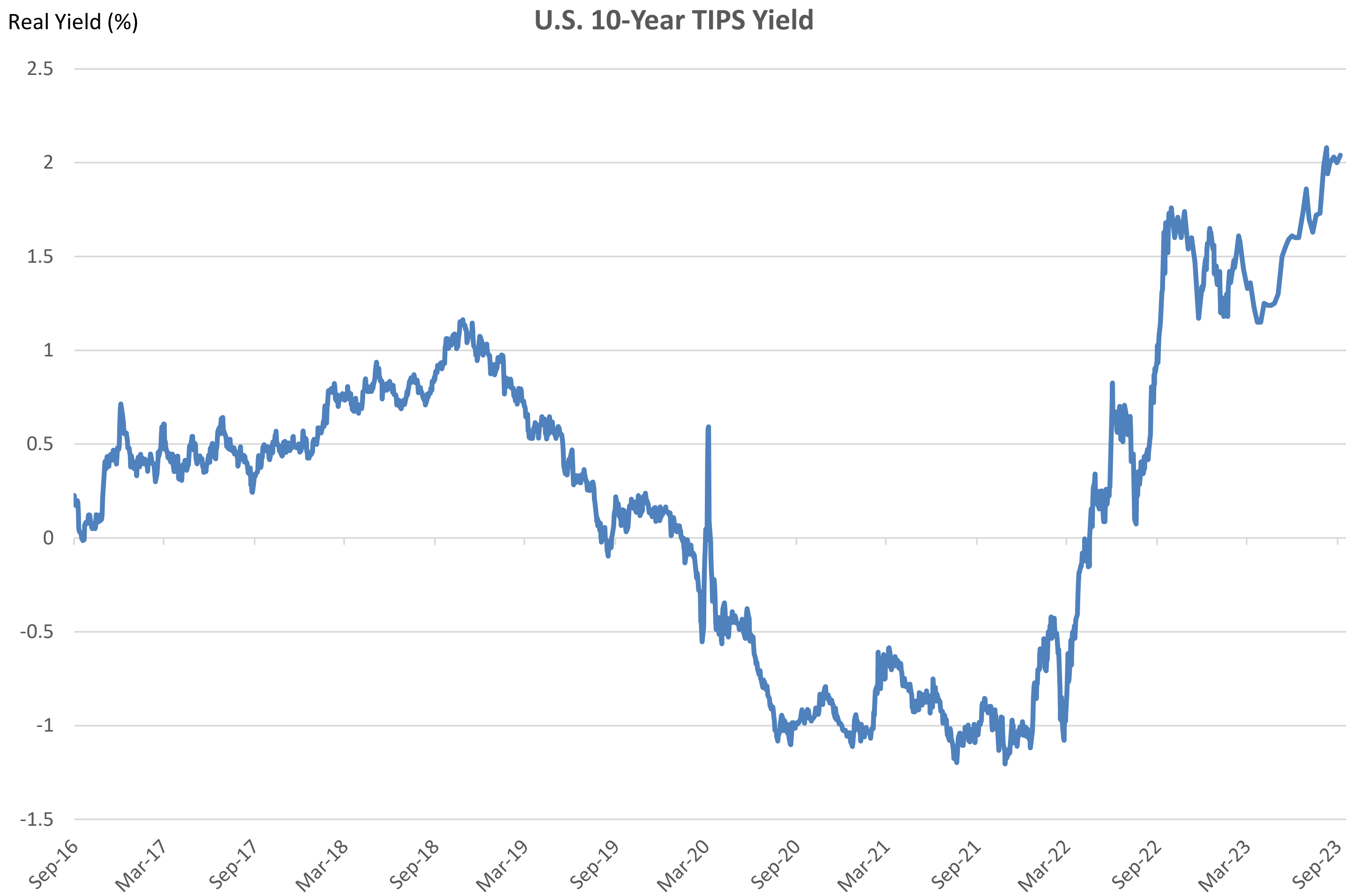
This bond re-challenged the 4.25% level, moving up to 4.34% and is at a 10-year high.

Source: Bloomberg, Odlum Brown

The yield curve remains inverted. Of note, the inversion has decreased by 25 basis points as two-year yields did not rise as much as 10-year yields.



High yield bond spreads remain near their lows for the past year. While the spreads have remained tight, the nominal yield on high yield bonds is close to 8% on average.



Source: Bloomberg, Odlum Brown

It has taken several years but real yields have now surpassed 2%.

Outlook

Inflation remains at the forefront of factors influencing bond yields and there is little doubt that it has crested globally. After three relatively mild CPI prints in the U.S., the market believes the Fed will pause in September but will likely hike again in November. Fed Chair Powell is on record as saying he would like to see several encouraging inflation reports before reconsidering the Fed's monetary stance. However, signs are pointing to a near-term setback in inflation. Not only is the spike in energy prices contributing to this view, but wage inflation appears to be meaningfully taking hold. Thus, the "higher-for-longer" view remains.

As for Canada, the Bank of Canada faces a deteriorating economy and a fragile housing industry, as borrowers are struggling with soaring mortgage rates. At the same time, inflation remains elevated and could rise further, the employment market remains firm, and wage inflation is on the rise. The Bank of Canada is likely to stand pat, no matter what the Federal Reserve does. Other central banks have not yet signaled a pause.

However, the factors that contributed to the recent increase in yields are likely to prevent market yields from retracing lower. Such factors include the resilient economy, the $2.3 trillion annual borrowing requirement by the U.S. Government, the Bank of Japan's move to tighten, and ongoing firmness in the important employment and housing sectors. Notably, the employment market has cooled steadily but remains healthy overall. Moreover, the Bank of Japan's decision to allow their 10-year bonds to move another 50 basis points higher, towards 1%, 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.

The strength in corporate bond markets and the accompanying tightening of yield spreads with government bonds argues against a recession this year. Thus, bond yields have challenged and exceeded 4.25% again with the U.S. 10-year maturity reaching 4.34%. Interestingly, the latest rise in the 10-year note was not matched by the movement in two-year yields. The yield curve is now less inverted by 25 basis points and this trend should continue.

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.

Fixed income investors have earned meager returns this year. As measured by the FTSE Bond Universe Index, year-to-date returns have been close to zero. Corporate bonds have returned close to 2%. 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 and possibly rise further during 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's an important question. Year to date, the bond market has produced a modest 0.18%, as measured by the FTSE Universe Index. Fixed income investors are being paid to wait with attractive short-term yields, which could move even higher depending on central bank actions.

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.