



MONTHLY FIXED INCOME UPDATE

Hank Cunningham

January 12, 2021

Interest Rate Summary	Dec-31-20	Dec-31-19	Dec-31-18	29-Dec-17	30-Dec-16	31-Dec-15
U.S.						
3-Month T-Bill	0.08%	1.55%	2.36%	1.38%	0.50%	0.16%
2-Year Treasury	0.12%	1.57%	2.49%	1.89%	1.19%	1.31%
10-Year Treasury	0.92%	1.92%	2.69%	2.41%	2.44%	2.27%
Canada						
3-Month T-Bill	0.06%	1.65%	1.64%	1.05%	0.45%	0.51%
2-Year Canada	0.20%	1.69%	1.86%	1.69%	0.74%	0.48%
10-Year Canada	0.68%	1.70%	1.97%	2.04%	1.72%	1.39%

Performance

	2020	2019	2018	2017	2016	2015	2014
DEX Universe Bond Index	8.68%	6.87%	1.41%	2.52%	3.52%	3.52%	8.79%
DEX Federal Bond Index	7.28%	3.73%	2.39%	0.13%	3.66%	3.66%	6.91%
DEX Provincial Bond Index	9.86%	9.07%	0.66%	4.33%	4.14%	4.14%	12.18%
DEX All Corporate Index	8.74%	8.05%	1.10%	3.38%	2.71%	2.71%	7.58%
DEX "A" Corporate Index	8.98%	9.65%	0.51%	4.42%	2.62%	2.62%	9.10%
DEX Real Return Bonds	13.02%	8.02%	-0.05%	0.72%	2.79%	2.79%	13.18%
DEX High Yield Bonds	6.69%	8.48%	2.15%	5.20%	13.79%	-5.58%	2.64%

All sectors produced positive performance in December and have recorded impressive gains for 2020. Real Return bonds produced the best returns, while high yield bonds were the laggards.

	Dec-31-20	Nov-30-20	Oct-30-20	Sep-30-20	Aug-31-20	Jul-31-20	Jun-30-20	May-29-20	Apr-30-20
U.S. 3-Month T-Bills	0.08%	0.08%	0.09%	0.10%	0.10%	0.09%	0.14%	0.14%	0.10%
U.S. 2-Year bonds	0.12%	0.15%	0.16%	0.13%	0.13%	0.11%	0.15%	0.16%	0.20%
U.S. 10-Year bonds	0.92%	0.84%	0.88%	0.69%	0.71%	0.53%	0.66%	0.65%	0.61%

Bond yields rose modestly in December. The U.S. ten-year note moved up by eight basis points; with the two-year yield anchored at 12 basis points, the yield curve steepened modestly.

The U.S. Federal Reserve Board continued to suppress yields with its massive asset purchase program, leaving little doubt that short-term rates would remain close to zero for the foreseeable future. The Bank of Canada adopted a similar stance.

Most economic data remained constructive in December in North America with many releases beating consensus estimates. These included: housing starts, retail sales, ISM manufacturing (biggest gain since 2018), leading indicators and jobless claims, to name a few. Consumer confidence fell in early December before the latest round of stimulus.

Globally, China is leading the way and Europe is stirring; PMIs are improving and unemployment rates are falling.

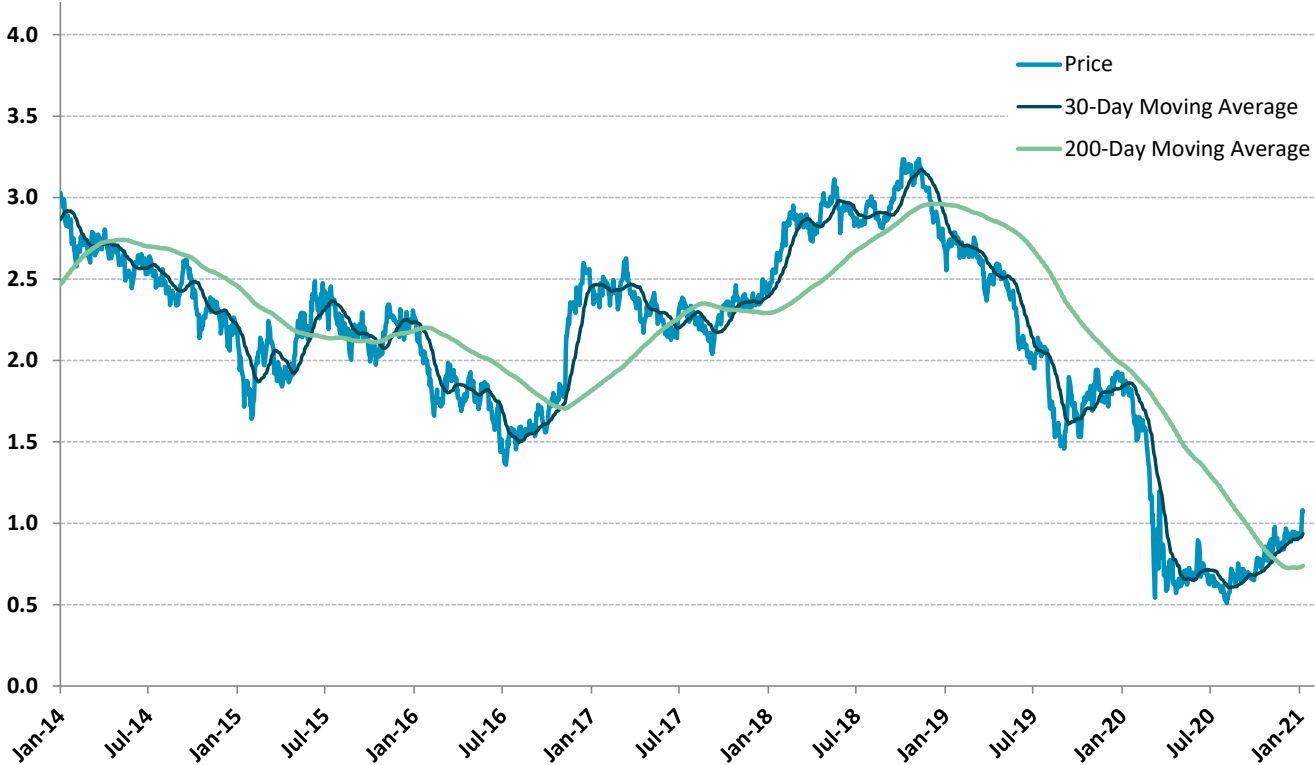
With the prospect of more stimulus to come along with the rollout of vaccines, economic prospects brightened, bringing heightened inflation expectations. The 10-year Breakeven Inflation Rate (BEIR) moved up to 2.12% early in 2021. Nominal yields also rose with the bellwether U.S. 10-year tacking on some 20 basis points since year end, decisively piercing the psychological 1% level and currently sitting at 1.16%.

Investment grade and high yield bonds continued to fall in yield in December. However, since year end, investment-grade bonds have tracked U.S. Treasury yields higher. High yield bond spreads have reached pre-pandemic levels.

The Canadian currency has continued to firm versus the U.S. dollar; the loonie has benefitted not only from the weak greenback but also from a nascent commodity price rally.

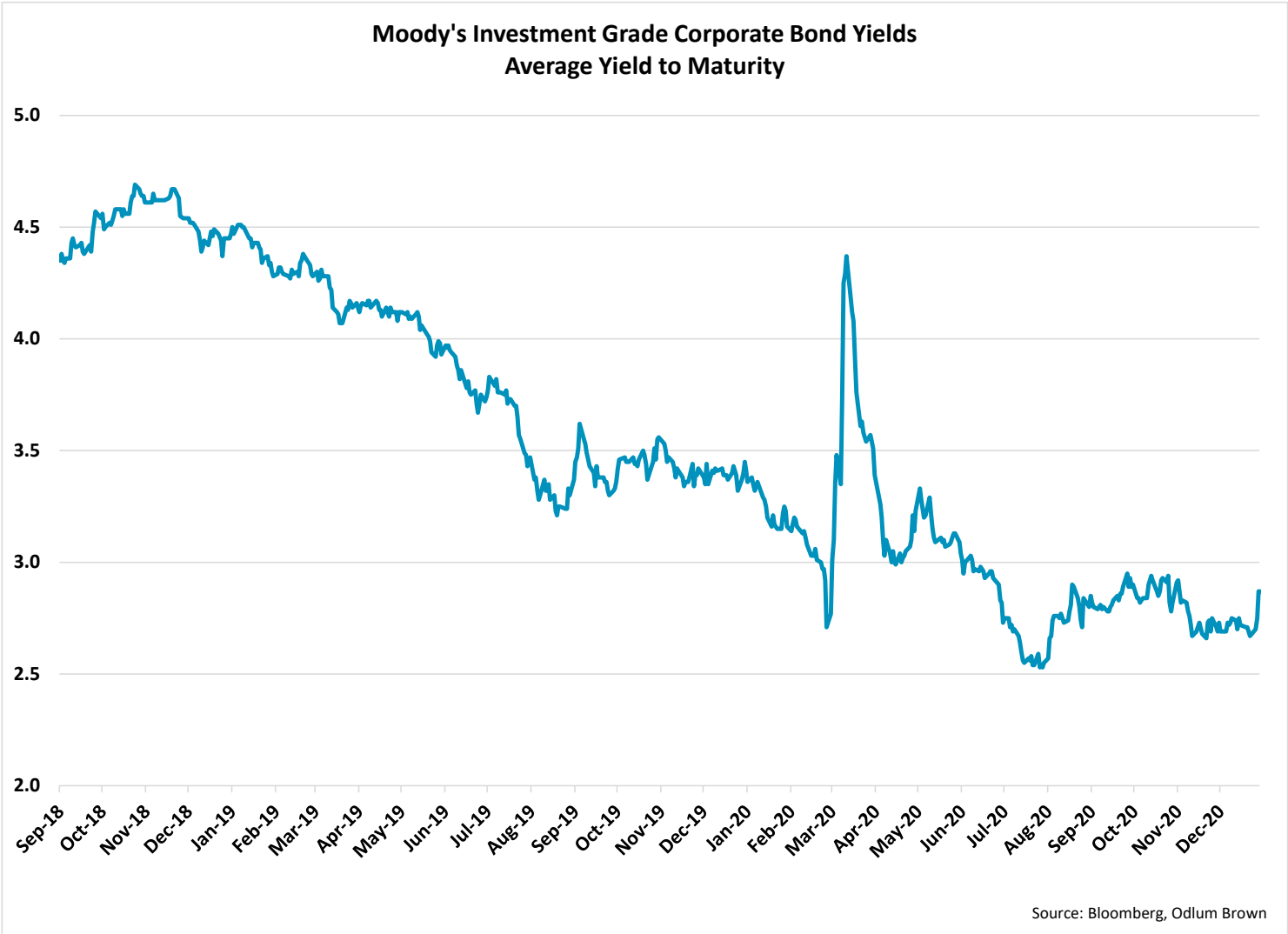
U.S. 10-Year Treasury

Yield (%)

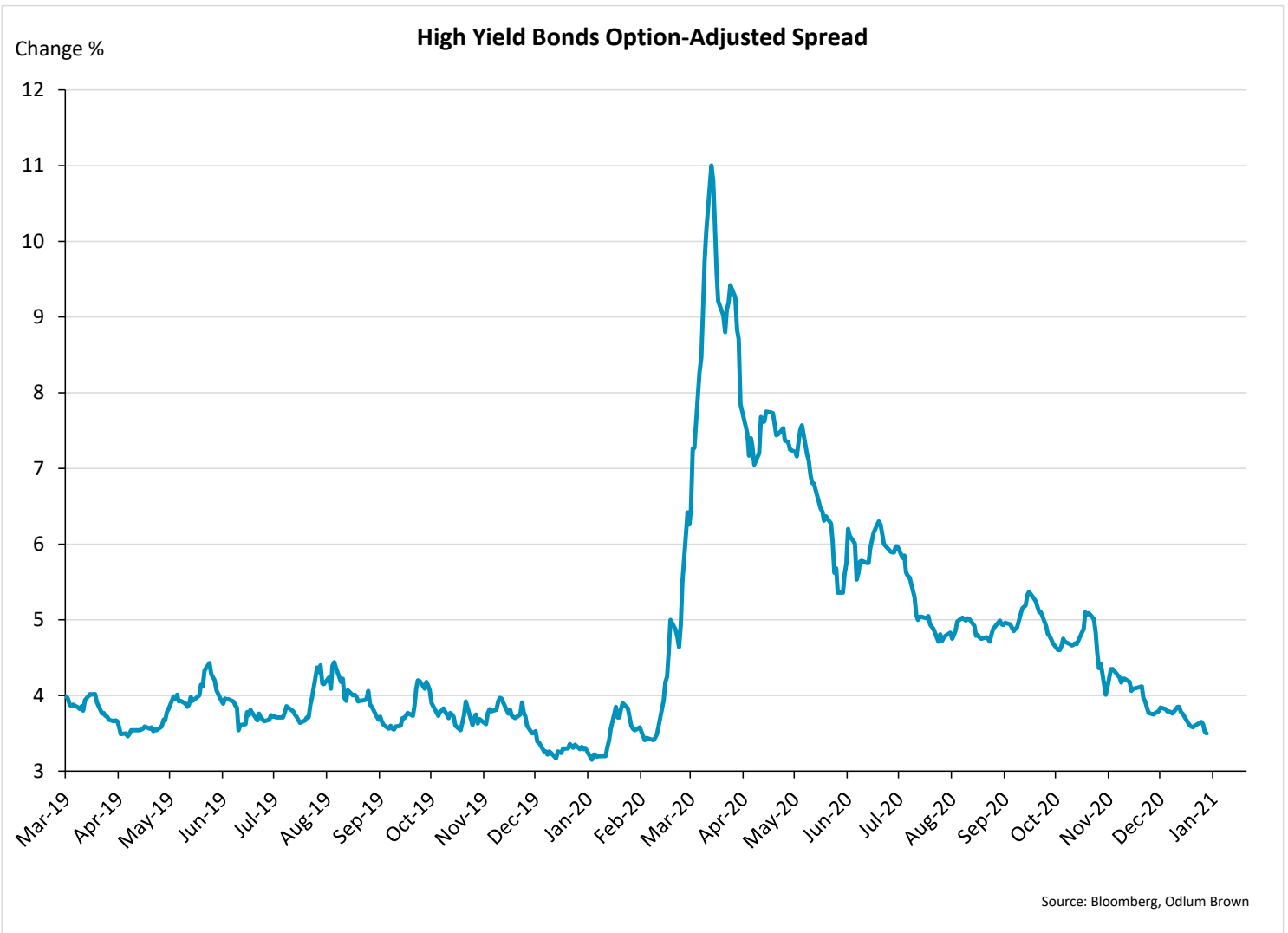


Source: Bloomberg, Odium Brown

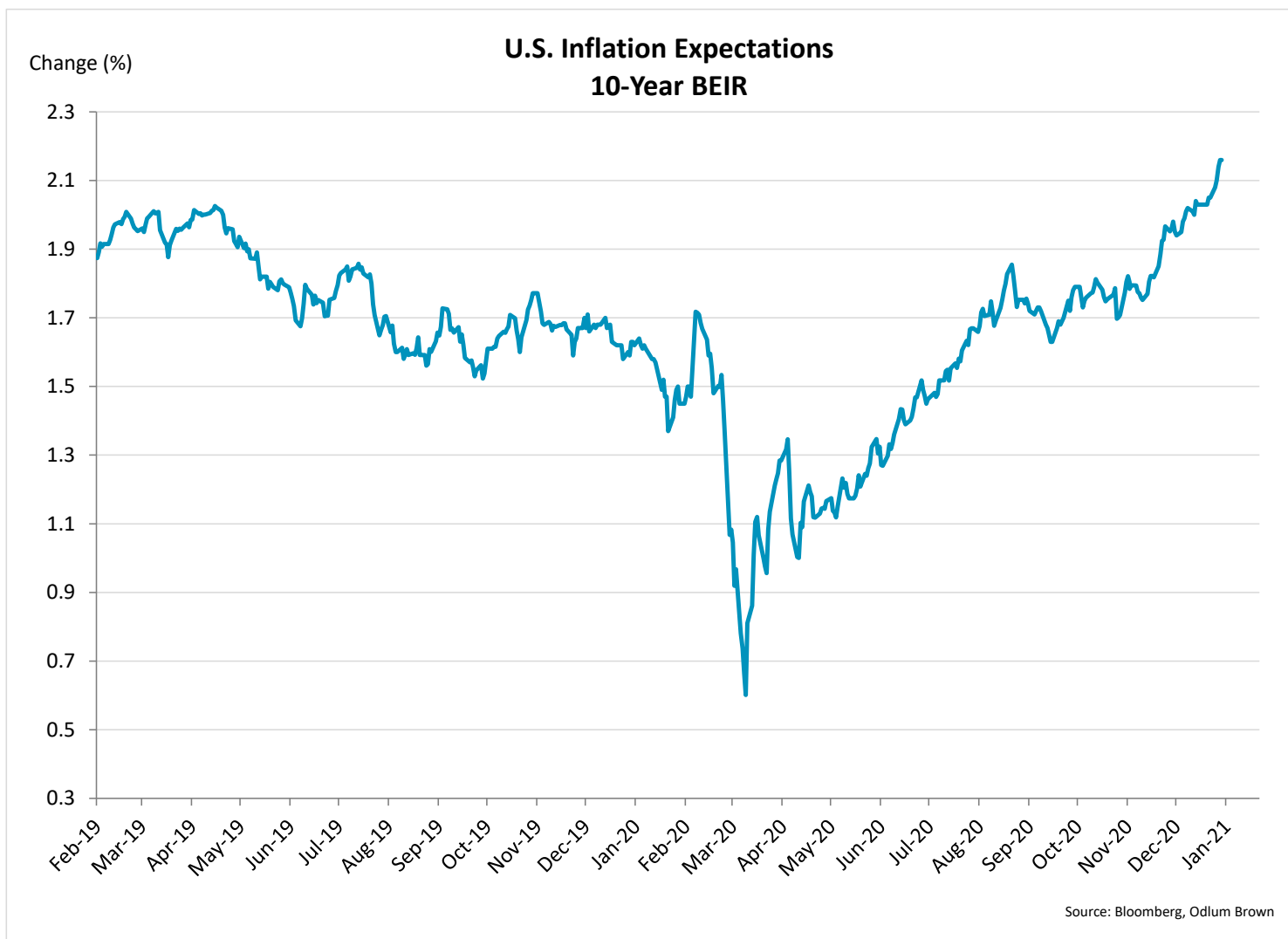
This global bellwether moved decisively above 1%.



Investment-grade corporate bond yields have begun to move higher with U.S. Treasury yields.



The high yield market resumed its rally after pausing for two months. Spreads have reached the pre-pandemic levels.



Inflation expectations have moved sharply above the important 2% level.

Outlook

Now that the U.S. ten-year yield is comfortably over 1% and inflation expectations are well over 2%, what is next? The new U.S. administration will likely be expansionary, providing even more stimulus. Along with the vaccine rollouts, growth prospects are improving. This should continue to heighten inflation worries. There remain headwinds for inflation, namely: demographics, technology and excess capacity. Nevertheless, we favour the reflation argument, which should produce higher bond yields, with the U.S. ten-year on its way to 1.25-1.50% in the medium term. With this forecast in mind, corporate bond yields have likely reached their nadir and will thus produce only modest returns henceforth.

Strategy

With this outlook for gradually rising bond yields, the number one theme for fixed income investors is preservation of capital. We continue to stress the importance of including high-quality fixed income securities in client portfolios. In this environment,

we favour non-cyclical corporate bonds of maturities less than five years, such as those issued by utilities, banks, telecommunications and recurring-revenue businesses. Corporate bonds will generate only modest returns this year but will outperform government bonds.

We have long recommended the laddered approach to fixed income investing. We continue to do so as a one-to-five year ladder has a short duration.

It may be time to recommend inflation-protected bonds, once it is clear that the recent acceleration in inflation is more than cyclical. It is challenging for investors to buy individual real return bonds. Thus, we counsel using ETFs.

For several years, we have had an approved list of outside fund managers. At present, in order to augment returns and benefit from their expertise in credit markets, we recommend two of these managers in particular, who are well positioned for this market environment. For further discussion, please speak to your Portfolio Manager or Investment Advisor.

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

Odlum Brown Limited is an independent, full-service investment firm focused on providing professional investment advice and objective research. We respect your right to be informed of relationships with the issuers or strategies referred to in this report which might reasonably be expected to indicate potential conflicts of interest with respect to the securities or any investment strategies discussed or recommended in this report. We do not act as a market maker in any securities and do not provide investment banking or advisory services to, or hold positions in, the issuers covered by our research. Analysts and their associates may, from time to time, hold securities of issuers discussed or recommended in this report because they personally have the conviction to follow their own research, but we have implemented internal policies that impose restrictions on when and how an Analyst may buy or sell securities they cover and any such interest will be disclosed in our report in accordance with regulatory policy. Our Analysts receive no direct compensation based on revenue from investment banking services. We describe our research policies in greater detail, including a description of our rating system and how we disseminate our research, on the Odlum Brown Limited website.

This report has been prepared by Odlum Brown Limited and is intended only for persons resident and located in all the provinces and territories of Canada, where Odlum Brown Limited's services and products may lawfully be offered for sale, and therein only to clients of Odlum Brown Limited. This report is not intended for distribution to, or use by, any person or entity in any jurisdiction or country including the United States, where such distribution or use would be contrary to law or regulation or which would subject Odlum Brown Limited to any registration requirement within such jurisdiction or country. As no regard has been made as to the specific investment objectives, financial situation, and other particular circumstances of any person who may receive this report, clients should seek the advice of a registered investment advisor and other professional advisors, as applicable, regarding the appropriateness of investing in any securities or any investment strategies discussed or recommended in this report.

This report is for information purposes only and is neither a solicitation for the purchase of securities nor an offer of securities. The information contained in this report has been compiled from sources we believe to be reliable, however, we make no guarantee, representation or warranty, expressed or implied, as to such information's accuracy or completeness. All opinions and estimates contained in this report, whether or not our own, are based on assumptions we believe to be reasonable as of the date of the report and are subject to change without notice.

Please note that, as at the date of this report, the Research Analyst responsible for the recommendations herein, associates of such Analyst and/or other individuals directly involved in the preparation of this report hold securities of some of the issuer(s) referred to directly or through derivatives.

No part of this publication may be reproduced without the express written consent of Odlum Brown Limited. Odlum Brown Limited is a Member of the Canadian Investor Protection Fund.
