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INVESTMENT RESEARCH

MONTHLY FIXED INCOME UPDATE

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Interest Rate Summary	Mar-31-22	Feb-28-22	Jan-31-22	Dec-31-21	Nov-30-21	Oct-29-21	Sep-29-21	Aug-31-21	Dec-31-20
U.S.									
3-Month T-Bill	0.50%	0.31%	0.19%	0.04%	0.05%	0.05%	0.04%	0.04%	0.08%
2-Year Treasury	2.34%	1.43%	1.16%	0.73%	0.57%	0.50%	0.28%	0.21%	0.12%
10-Year Treasury	2.34%	1.83%	1.77%	1.51%	1.45%	1.56%	1.49%	1.31%	0.92%
Canada									
3-Month T-Bill	0.73%	0.57%	0.34%	0.17%	0.06%	0.15%	0.13%	0.16%	0.06%
2-Year Canada	2.29%	1.43%	1.25%	0.95%	0.98%	1.09%	0.53%	0.42%	0.20%
10-Year Canada	2.40%	1.81%	1.77%	1.42%	1.57%	1.72%	1.51%	1.21%	0.68%

Performance	YTD	2021	2020	2019	2018	2017	2016
DEX Universe Bond Index	-6.97%	-2.54%	8.68%	6.87%	1.41%	2.52%	3.52%
DEX Federal Bond Index	-5.55%	-2.62%	7.28%	3.73%	2.39%	0.13%	3.66%
DEX Provincial Bond Index	-8.57%	-3.28%	9.86%	9.07%	0.66%	4.33%	4.14%
DEX All Corporate Index	-6.45%	-1.34%	8.74%	8.05%	1.10%	3.38%	2.71%
DEX "A" Corporate Index	-6.91%	-2.30%	8.98%	9.65%	0.51%	4.42%	2.62%
DEX Real Return Bonds	-9.33%	1.84%	13.02%	8.02%	-0.05%	0.72%	2.79%
DEX High Yield Bonds	-3.13%	6.18%	6.69%	8.48%	2.15%	5.20%	13.79%

Comments:

Bond yields rose at all maturities in the first quarter of 2022 and they have continued to climb higher in April. The U.S. two-year note has jumped 160 basis points, while the ten-year has moved 120 basis points higher so far this year. Real Return bonds have suffered the most due to a rise in real yields of 100 basis points. Their performance has been adversely affected by their low coupon and long duration characteristics.

The rise in bond yields in April has been driven by the twin forces of inflation and a hawkish Federal Reserve. The U.S. ten-year reached 2.34% at the end of March but has surged to 2.90% at present. This bond's yield reached as low as 1.73% in February when the Russian conflict erupted in Ukraine, resulting in a flight to quality.

The yield curve flattened significantly with the spread between two-year and ten-year bond yields briefly inverting before returning to the present positive spread of 30 basis points.

Inflation has been the key statistic this year. The March Consumer Price Index (CPI) reading was 8.5% on a year-over-year basis, the highest it's been since 1982. More importantly, it shows no signs of slowing, although some analysts see preliminary signs of it peaking.

The Federal Reserve does not think so; after raising the Fed Funds rate by 25 basis points in March, it has left little doubt that more hikes are coming, possibly 50 basis points at a time. Notably, it laid out its strategy to reduce its balance sheet by $95 billion per month, also known as quantitative tightening.

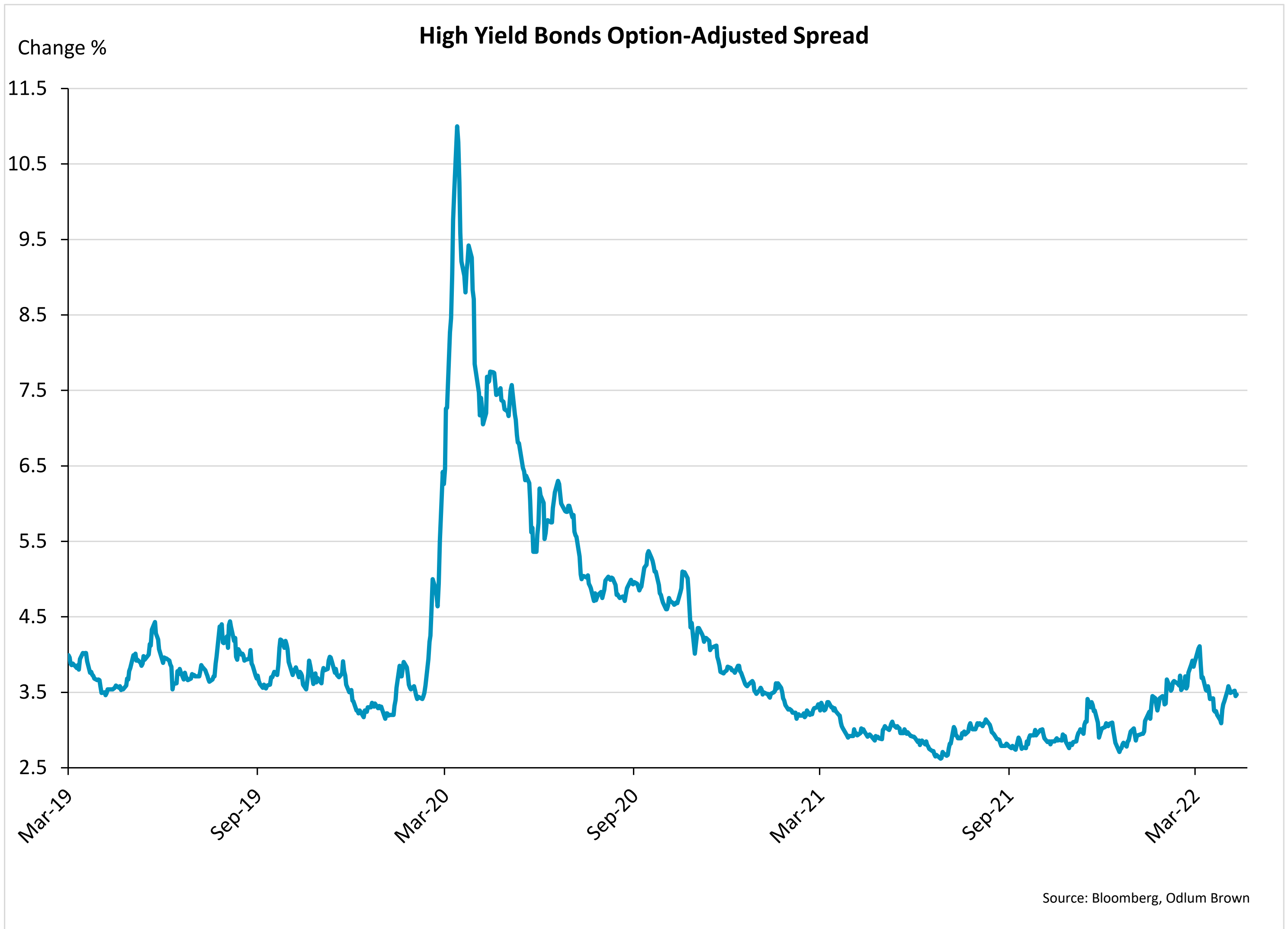
At the same time, the labour market remained taut with the unemployment rate hitting 3.7% and wage pressures evident. There are 11 million job openings in the United States, more than the number of unemployed by approximately two million.

Canada has also enjoyed buoyant economic times with a record trade surplus and a blowout employment report. The Bank of Canada followed through on its forecast by raising its key rate by 25 basis points in March and by another 50 basis points on April 13, also signaling its end to quantitative easing (QE). Most recently, Canada reported a surge in inflation, well above consensus. This seals the likelihood of another 50 basis point hike in Canada's overnight rate.

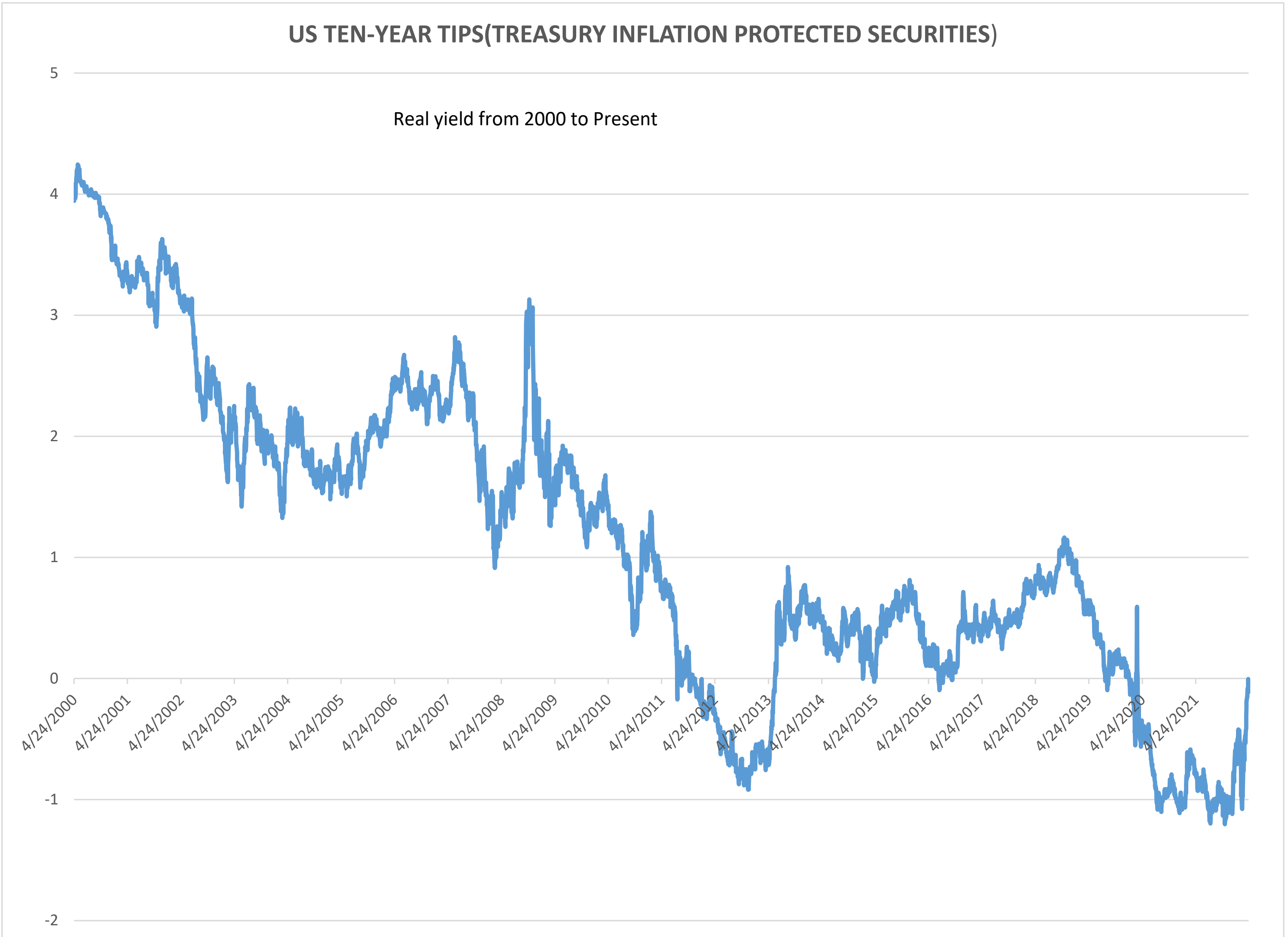
U.S. 10-Year Treasury

This bellwether's yield has soared despite being interrupted by a couple of significant flights to quality. Inflation, a tight employment situation and a hawkish Federal Reserve have all contributed to this rise in bond yields. The next major technical hurdle is 3.25%; however, periodic rallies are likely after such a swift selloff.

Investment-grade corporate yields have soared with U.S. Government yields. Spreads have been well behaved.



Demand for high yield bonds has eased considerably. Spreads have widened 75 basis points this year but have been relatively stable of late.



Historically, fixed income investors received yields *in excess of inflation* averaging 2%. The massive monetary stimulus and QE programs combined to drive real yields deep into negative territory. Now that monetary tightening is a reality, including the reduction of the Fed's bloated $9 trillion balance sheet, real yields have begun to climb and are approaching zero.

TIPS are long-term, low coupon bonds and as such, have long-term duration and considerable price volatility. They have been the worst performers of the fixed income markets this year. This poor performance is likely to continue. A rise in real yields to 1% and then 2% would result in steep price declines of a further 10% and 20%.

The Federal Reserve and the Bank of Canada have begun removing monetary accommodation and there is more tightening to come. To date, there has been little impact on economic data nor has the geopolitical conflict fed into the mix. Indeed, the Fed has maintained a positive economic outlook and is forecasting the inflation rate to average out at 4.3% for 2022. Many central banks, including the Bank of Canada, the Bank of England and the ECB, have joined the Fed in tightening.

The Fed and the Bank of Canada have discussed their plan to return to the so-called "neutral" level for their key lending rates. This rate is projected to be 2.5% and is likely to occur, barring a major exogenous shock.

It is reasonable, however, to acknowledge that growth, both domestic and global, will suffer somewhat. Indeed, the IMF has downgraded global economic growth prospects for this year and next to 3.6% versus previous estimates of 4.4% and 3.8%, respectively.

Consumer sentiment has ebbed but retail sales have held up. A major concern is whether capital spending is reduced or delayed. At the same time, the geopolitical landscape has produced widespread uncertainty, and even more inflationary pressure.

Real yields are rising rapidly but still remain negative. A combination of further increases in bond yields, plus some easing in inflation will result in real yields turning positive.

Thus, we expect yields at all maturities to gain further with a 3.25% target for the bellwether ten-year U.S. note. Corporate bond yields will move up in at least a similar fashion and possibly widen further from Treasury yields. Corporate financial health remains solid.

Wage pressures are escalating and may prevent the inflation rate from falling back to the 2% level. Commodity prices have soared of late too. Long-term deflationary pressures, such as demographics and technology, will re-emerge eventually and help ease inflation. Overall, inflation will be slow to subside, with most forecasts, including those from central banks, estimating it to land between 4-5% this year.

It is likely that the Fed will be flexible in its monetary policy, owing to the uncertainty surrounding growth and the geopolitical conflict. Already, the market has discounted several rate hikes and thus markets are not likely to react in a knee-jerk fashion. Also, the beginning of QT by the Fed and other central banks will impact market yields negatively.

Given this outlook, returns for fixed income investors will continue to be disappointing.

Strategy

Inflation is the enemy of bond investors and will remain a major negative for the foreseeable future.

Thus, this continues to be a time to defend principal as long-term bonds carry significant potential for capital loss if interest rates rise. Thus, we counsel investors not to reach for yield, but instead to invest in short-term, high-quality corporate bonds.

This approach will defend principal while producing modest returns. Floating-rate bonds offer the promise of higher returns with minimal risk to principal as short-term yields continue to climb.

Specifically, we recommend a laddered approach using the **Odlum Brown Corporate Bond Ladder**. GICs could be used in the ladder as well. Also, we recommend individual floating-rate bonds.

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.

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