Monthly Fixed Income Update

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April 22, 2024

Interest Rate Summary	Mar-29-24	Feb-29-24	Jan-31-24	Dec-29-23	Nov-30-23	Oct 31-23	Sep 29-23	Aug 31-23	Jul 31-23
U.S.									
3-Month T-Bill	5.37%	5.38%	5.37%	5.34%	5.39%	5.47%	5.45%	5.45%	5.42%
2-Yr Treasury	4.62%	4.62%	4.21%	4.25%	4.68%	5.09%	5.05%	4.87%	4.88%
10-Yr Treasury	4.20%	4.25%	3.91%	3.88%	4.33%	4.93%	4.57%	4.11%	3.96%
Canada									
3-Month T-Bill	5.20%	4.96%	5.00%	5.04%	5.02%	5.02%	5.11%	5.12%	5.04%
2-Year Canada	4.18%	4.18%	3.97%	3.89%	4.19%	4.64%	4.87%	4.64%	4.67%
10-Year Canada	3.47%	3.49%	3.32%	3.11%	3.55%	4.06%	4.02%	3.56%	3.50%

Performance	YTD*	2023	2022	2021	2020	2019	2018
DEX Universe Bond Index	-2.96%	6.69%	-11.69%	-2.54%	8.68%	6.87%	1.41%
DEX Federal Bond Index	-2.51%	5.00%	-9.34%	-2.62%	7.28%	3.73%	2.39%
DEX Provincial Bond Index	-4.83%	7.31%	-15.05%	-3.28%	9.86%	9.07%	0.66%
DEX All Corporate Index	-1.06%		-11.54%	-1.34%	8.74%	8.05%	1.10%
DEX "A" Corporate Index	-1.45%	8.23%	-9.87%	-2.30%	8.98%	9.65%	0.51%
DEX Real Return Bonds	-4.68%	1.99%	-14.32%	1.84%	13.02%	8.02%	-0.05%
DEX High Yield Bonds	3.14%	10.00%	-5.44%	6.18%	6.69%	8.48%	2.15%

**As of April 22, 2024*

Comments

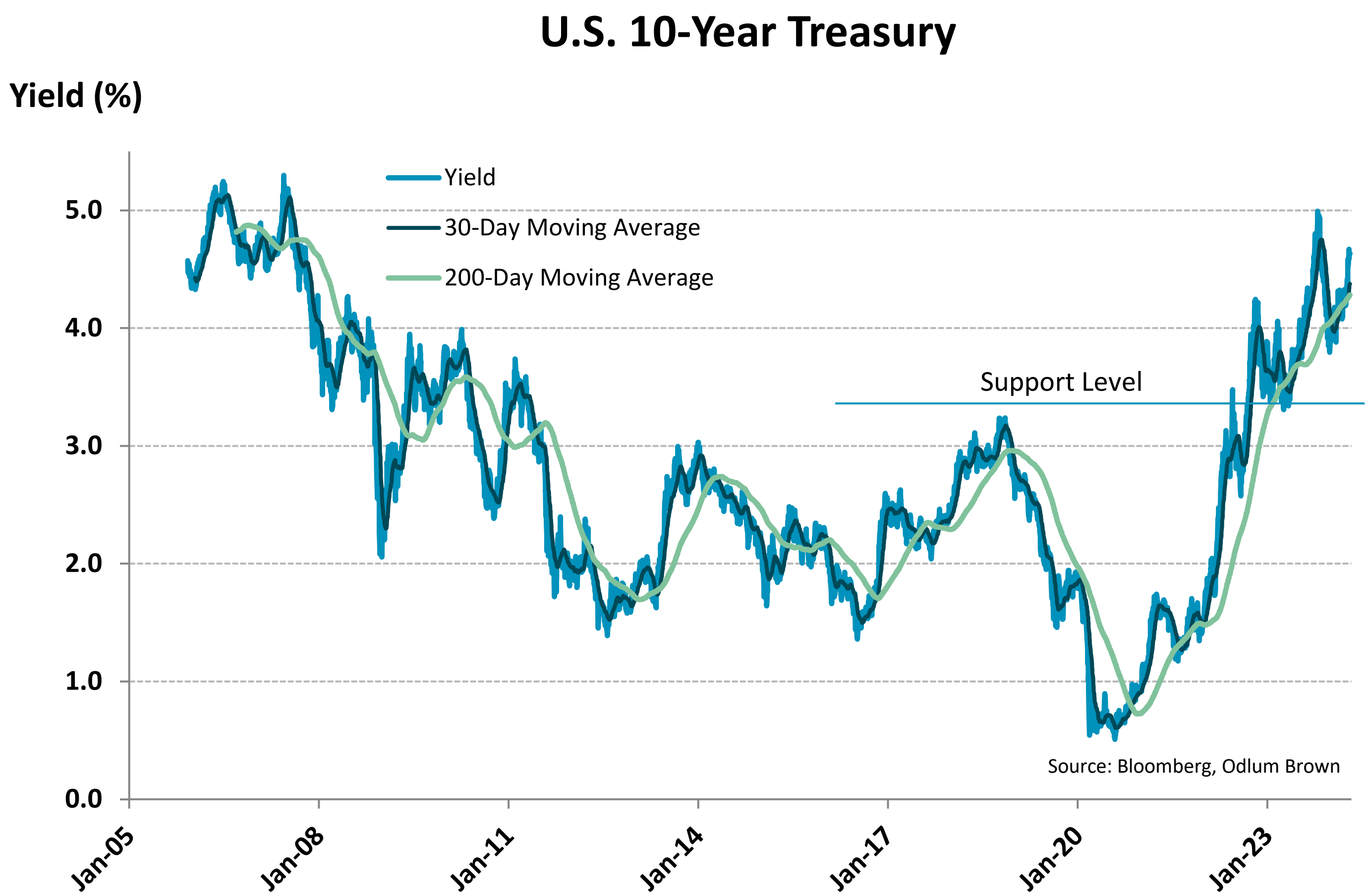
After the dramatic year-end rally in the bond market (and decline in yields), bond yields have generally increased. The yield on the 10-year U.S. Treasury was 4.25% at the end of February, a meaningful increase from 3.88% at year end. That yield fell to 4.20% at the end of March but has since risen to 4.65%. Recent reports again demonstrated inflation's stickiness, contributing to rising bond yields. This further underscores that the Fed needs to be patient before cutting its rate.

The increase in bond yields occurred despite widespread macro forecasts, erroneously calling for a recession and reductions in the Fed Funds Rate in the near term.

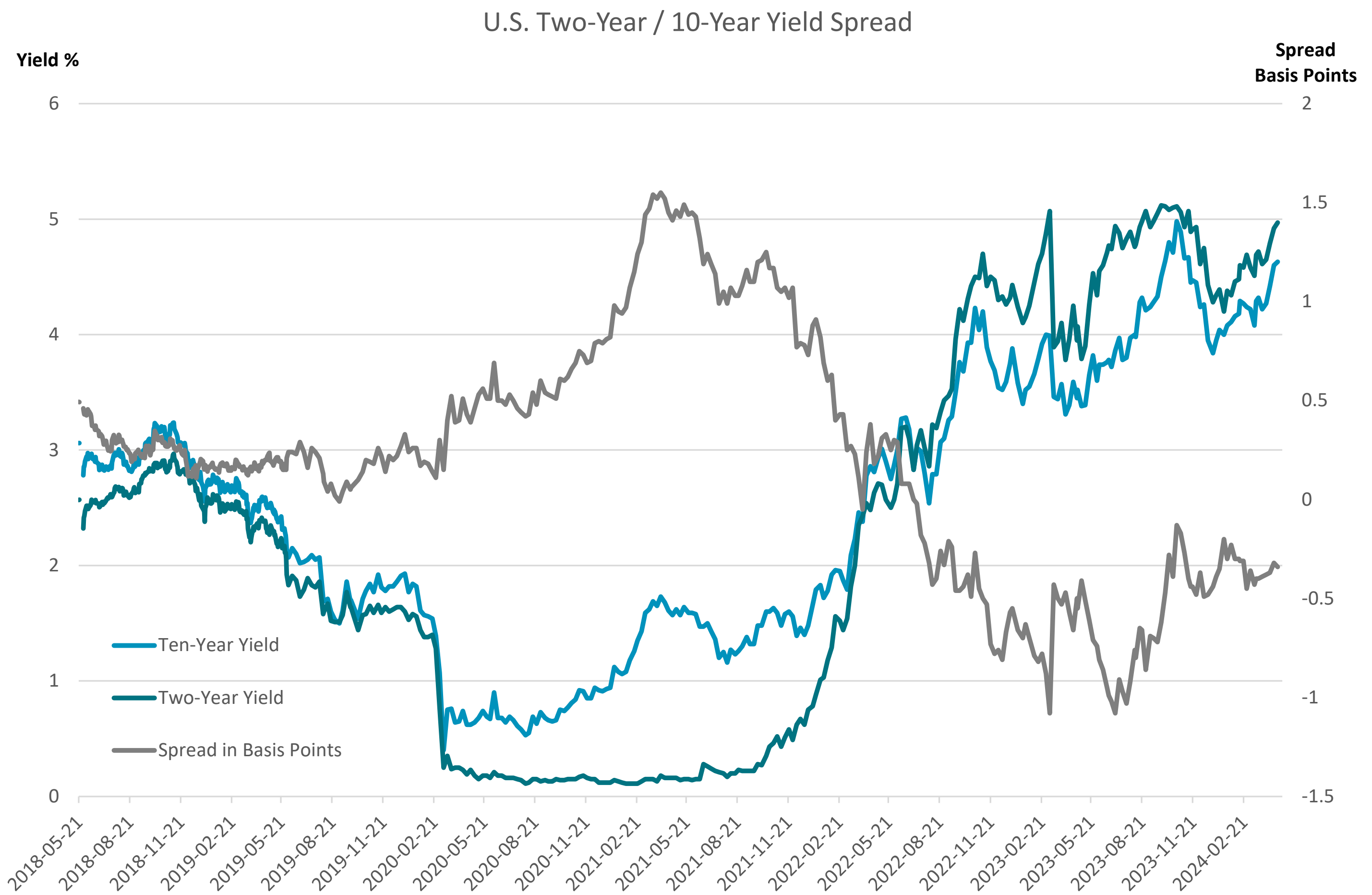
The Federal Reserve Open Market Committee voted to leave the Fed Funds Rate unchanged at its meeting in March. Fed Chair Powell made it clear they were in no hurry to lower rates, effectively dashing hopes for a cut in June. Since then, a string of fresh economic data has underscored the economy's resiliency, making the case more difficult for further easing of inflationary pressures. In addition, the latest employment report displayed strength, although the unemployment rate edged higher. Consumer sentiment has finally weakened under the somewhat pessimistic inflation trend.

Canada reported weaker inflation, with our core rate falling to 3.6%. This led to immediate speculation of an early rate reduction. However, on March 6, the Bank of Canada stated that it remains wary of inflation trends after signs that the economy was firming. Indeed, since then, Canada's GDP perked up, compounding the Bank's dilemma.

The corporate bond market, both investment grade and high yield, has been active as treasurers have taken advantage of attractively narrow yield spreads from government bonds. In fact, the corporate bond market easily absorbed a record issuance of investment-grade bonds in the first quarter of 2024. The U.S. Government bond market has thus far absorbed the extremely large auctions with relative ease with only one or two weak results.



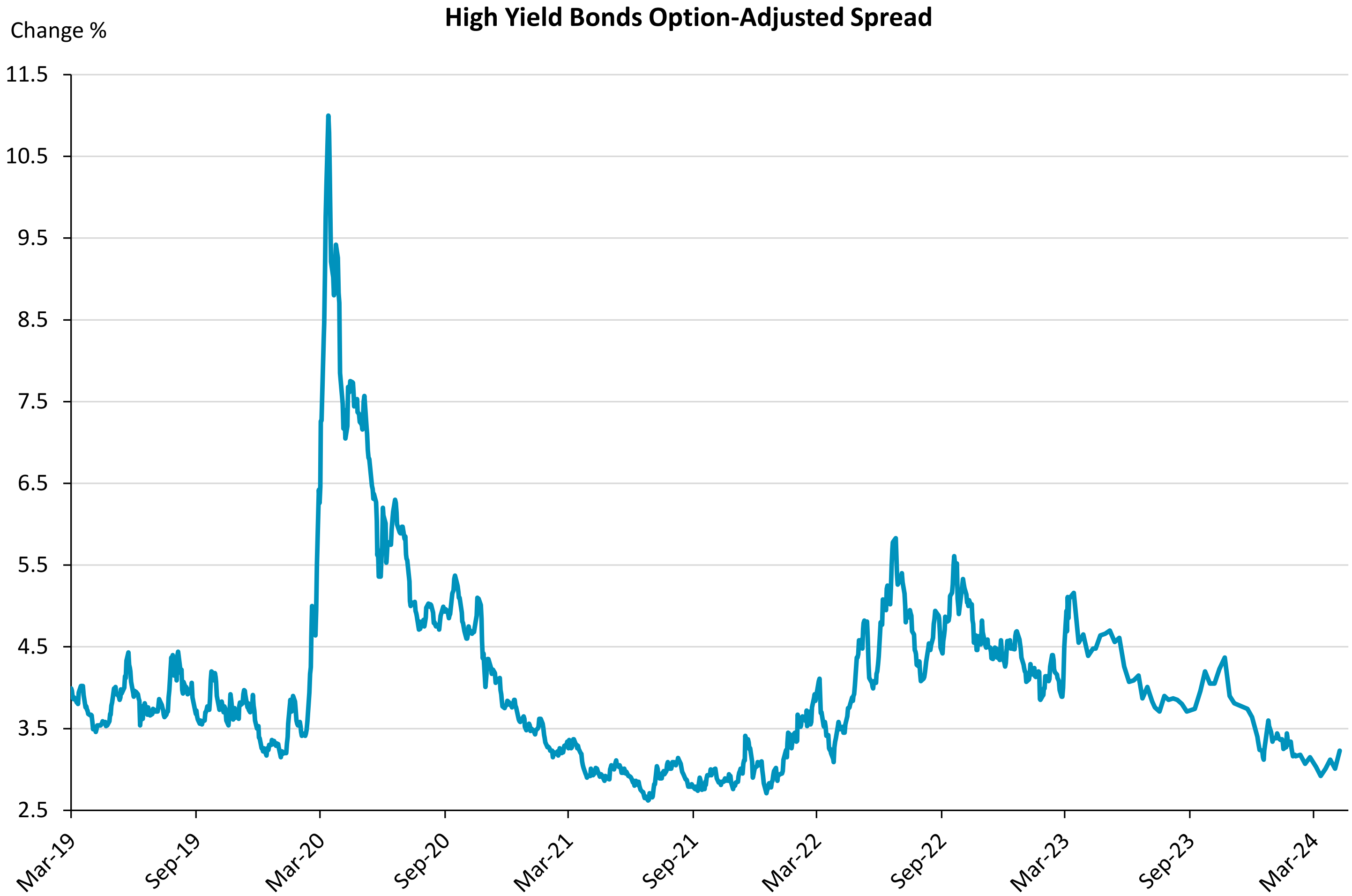
After reaching a 16-year high of 5% this bond plunged to 3.88% but has since soared above its 200-day moving average to 4.64%.



Source: Bloomberg, Odlum Brown

The yield curve remains stubbornly inverted but well below peak inversion.

High Yield Bonds Option-Adjusted Spread



Source: Bloomberg, Odlum Brown

High yield bond spreads are close to the lows for the past year.

“Higher for longer.”

- Fed Chairman, Jerome Powell

Outlook

As time goes on and economic and inflation data signal an expanding U.S. economy, the odds of an early reduction in the Fed Funds Rate are falling with a building consensus that there will be no such cuts this year. The Bank of Canada is poised, along with the ECB, to reduce its key rate before the Fed does.

The inflation outlook remains paramount to the bond market. After two successive releases, which were above consensus, it appears that inflation may bottom at 3%.

Economists are preoccupied with what kind of “landing” the U.S. economy will experience: will it be hard, soft or nonexistent? Too much time has been spent forecasting the next recession. Meanwhile, the economy, seemingly ignoring the Fed’s monetary stance, is growing at a 3% pace.

There will be no change in the monetary stance in the U.S. or Canada in the near term. While the Fed has stated that three rate reductions are possible this year, the timing of them has been pushed out, perhaps to next year. The recent CPI reports underscore inflation’s tenacity, meaning a rate reduction could be counterproductive. What is more probable is a gradual move to lower rates with the Fed Funds rate possibly moving 50 to 75 basis points lower over the next twelve months.

A similar scenario is unfolding in Canada after GDP growth picked up towards the end of 2023, putting the Bank of Canada on the sidelines, and reiterating its cautious stance during its recent deliberations.

Another important factor is that the Bank of Japan has begun to tighten its monetary policy, which could lead Japanese investors to sell their U.S. Treasury bonds.

With the recent economic strength, accompanied by escalating wages, it will likely prove difficult for inflation to reach the 2% target. Should that prove to be the case, it stands to reason that longer-term bond yields should rise. It is our view that investors are not being adequately compensated for owning long-term bonds, especially if inflation bottoms at 3%. This also reflects the massive government borrowing requirements as there is no attempt to rein in federal deficits. In addition, the Federal Reserve is still engaged in quantitative tightening (QT). The Bank of Canada is also continuing its QT program. The net effect will ultimately be a return to a positive yield curve, with short- and mid-term yields likely falling below longer-term yields. Still, the normalization of the yield curve probably won’t happen until the latter part of the year.

Strategy

Short-term bonds are attractive as the yield curve remains inverted as they offer principal protection. Given our somewhat bearish view on longer-term bond yields, we continue to counsel a defensive approach to fixed income investments, with a duration no longer than three years. With corporate bond yield spreads tight to government issues, we recommend two- to four-year Government bonds, both Federal and Provincial. As the year wears on and the likelihood increases that the Bank of Canada will begin to reduce its overnight rate, the yield curve will normalize.

This year’s increase in yields has caused bonds issued at lower yields to trade at deep discounts to their par values. These have proved to be 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 several 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 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.