Monthly Fixed Income Update

Hank Cunningham

August 11, 2022

Interest Rate Summary	Jul-29-22	Jun-30-22	May-31-22	Apr-29-22	Mar-31-22	Feb-28-22	Dec-31-21	Nov-30-21	Dec-31-20
U.S.									
3-Month T-Bill	2.36%	1.67%	1.06%	0.83%	0.50%	0.31%	0.04%	0.05%	0.08%
2-Year Treasury	2.89%	2.96%	2.56%	2.72%	2.34%	1.43%	0.73%	0.57%	0.12%
10-Year Treasury	2.65%	3.02%	2.85%	2.94%	2.34%	1.83%	1.51%	1.45%	0.92%
Canada									
3-Month T-Bill	2.65%	2.09%	1.47%	1.44%	0.73%	0.57%	0.17%	0.06%	0.06%
2-Year Canada	2.96%	3.09%	2.66%	2.62%	2.29%	1.43%	0.95%	0.98%	0.20%
10-Year Canada	2.61%	3.22%	2.89%	2.86%	2.40%	1.81%	1.42%	1.57%	0.68%

Performance	YTD	2021	2020	2019	2018	2017	2016
DEX Universe Bond Index	-8.81%	-2.54%	8.68%	6.87%	1.41%	2.52%	3.52%
DEX Federal Bond Index	-6.62%	-2.62%	7.28%	3.73%	2.39%	0.13%	3.66%
DEX Provincial Bond Index	-11.24%	-3.28%	9.86%	9.07%	0.66%	4.33%	4.14%
DEX All Corporate Index	-8.10%	-1.34%	8.74%	8.05%	1.10%	3.38%	2.71%
DEX "A" Corporate Index	-8.85%	-2.30%	8.98%	9.65%	0.51%	4.42%	2.62%
DEX Real Return Bonds	-10.71%	1.84%	13.02%	8.02%	-0.05%	0.72%	2.79%
DEX High Yield Bonds	-6.45%	6.18%	6.69%	8.48%	2.15%	5.20%	13.79%

Comments

After six consecutive months of rising market yields and negative performance, bond yields fell in July and thus far in August, reversing some of those negative returns. The bellwether 10-year U.S. Treasury note reached a peak of 3.50% and then fell to 2.50% before settling at 2.70%. The yield curve, as measured by the yield spread between the two-year and 10-year Treasury yields, inverted to the tune of 50 basis points.

Central to what has happened here is the recession watch. Indeed, several signs of weaker economic growth have emerged, particularly in the important areas of housing and consumer confidence. However, employment and manufacturing remain strong. In addition, the high yield bond market has demonstrated strength with spreads narrowing, an unlikely development in a recessionary environment.

After the most recent Consumer Price Index (CPI) print was tamer than expected, speculation is growing that the Fed will adjust its monetary policy and only hike rates by 50 basis points in September.

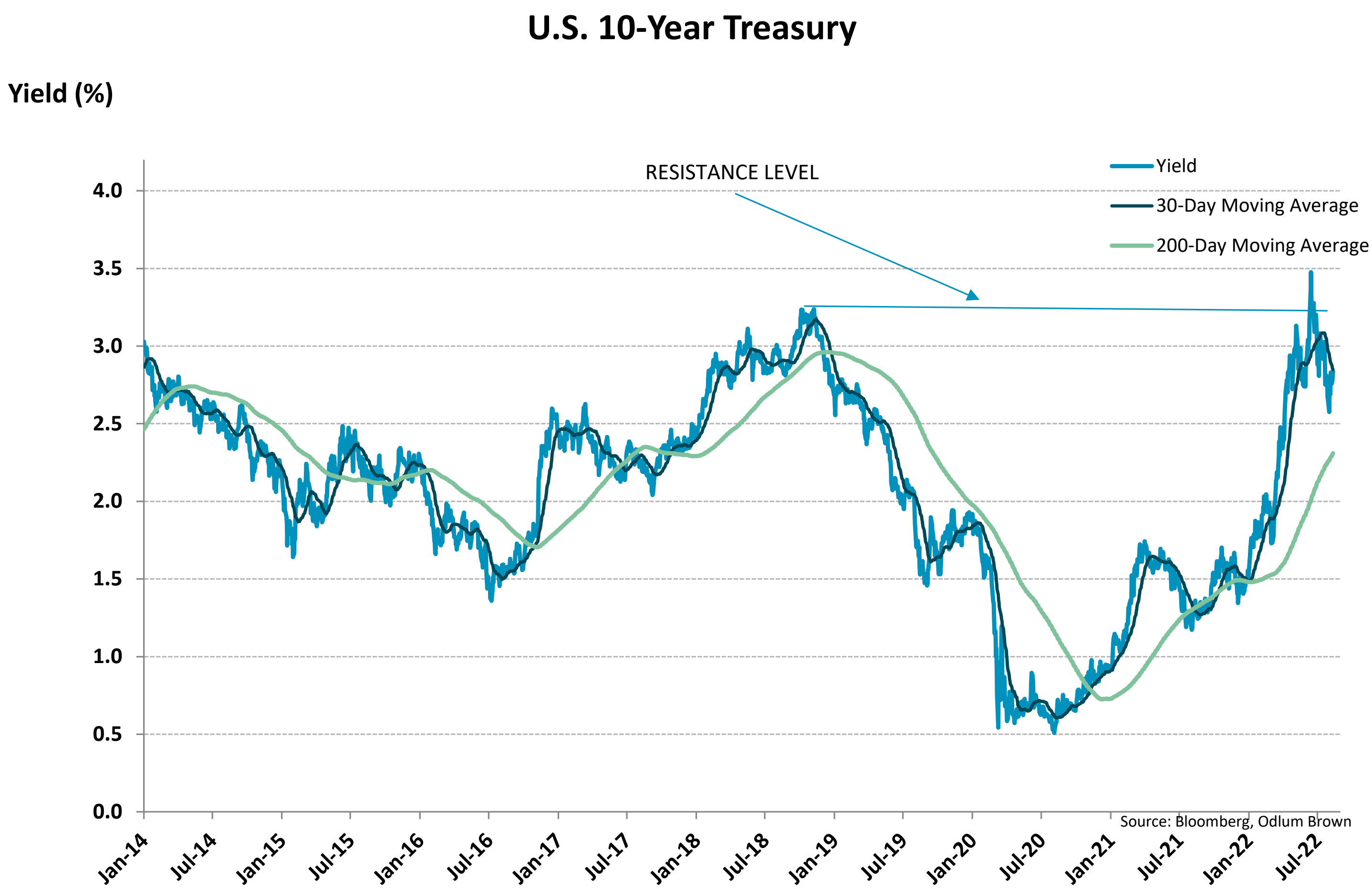
Inflation has been the key statistic this year. The CPI reading for July was 8.5% on a year-over-year basis, down from the recent high of 9.1%, and shows signs of ebbing further.

Importantly, the labour market remained taut with the unemployment rate hitting 3.5% and wage pressures growing, with increases beginning to settle in at 5%. There are 10.7 million available jobs in America, far more than the number of unemployed.

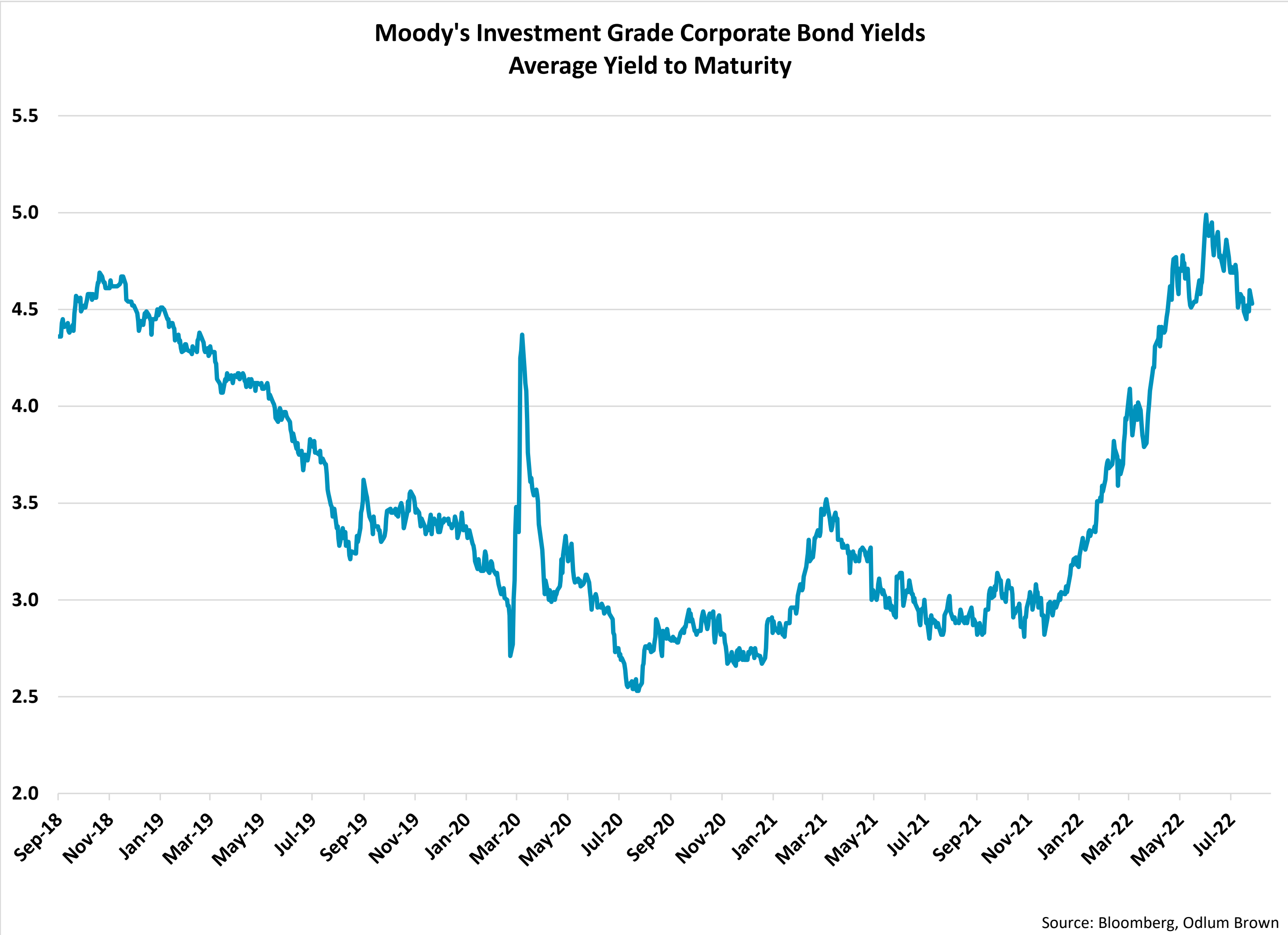
Canada has also enjoyed buoyant economic times with two consecutive record trade surplus prints. However, the Canadian economy shed jobs for two straight months even though the unemployment rate fell to 4.9%.

The Bank of Canada followed through on its forecast by raising its key rate by a full 100 basis points on July 13, bringing the year-to-date increase to 2%. The bank also confirmed it would continue its quantitative tightening program. In a hawkish statement, it reaffirmed its desire to raise rates further at its next meeting on September 7.

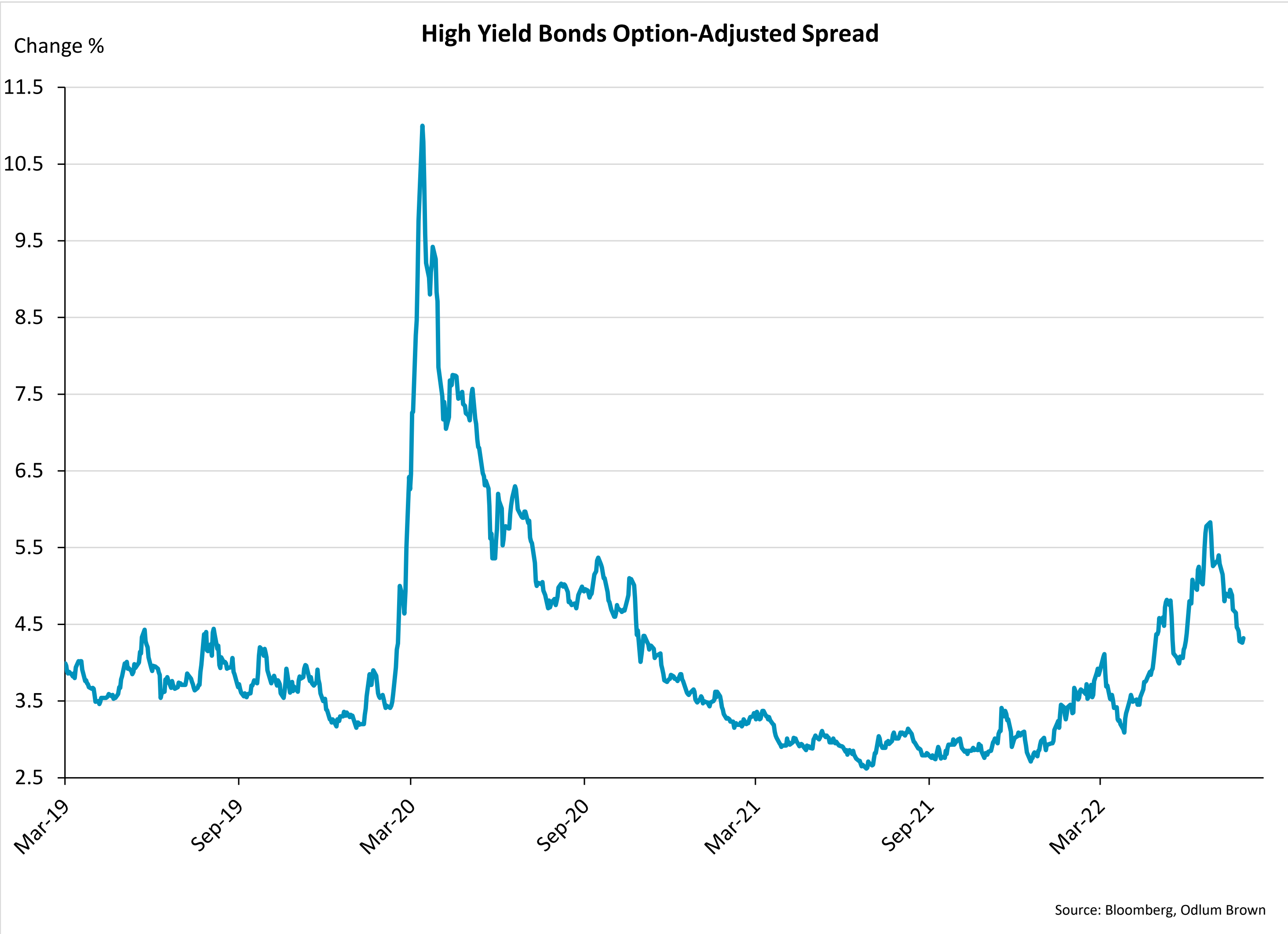
The corporate bond market, in both the U.S. and Canada, remains healthy, with the resumption of a normal borrowing calendar, along with a narrowing of spreads to government bond yields, particularly in the high yield bond market.



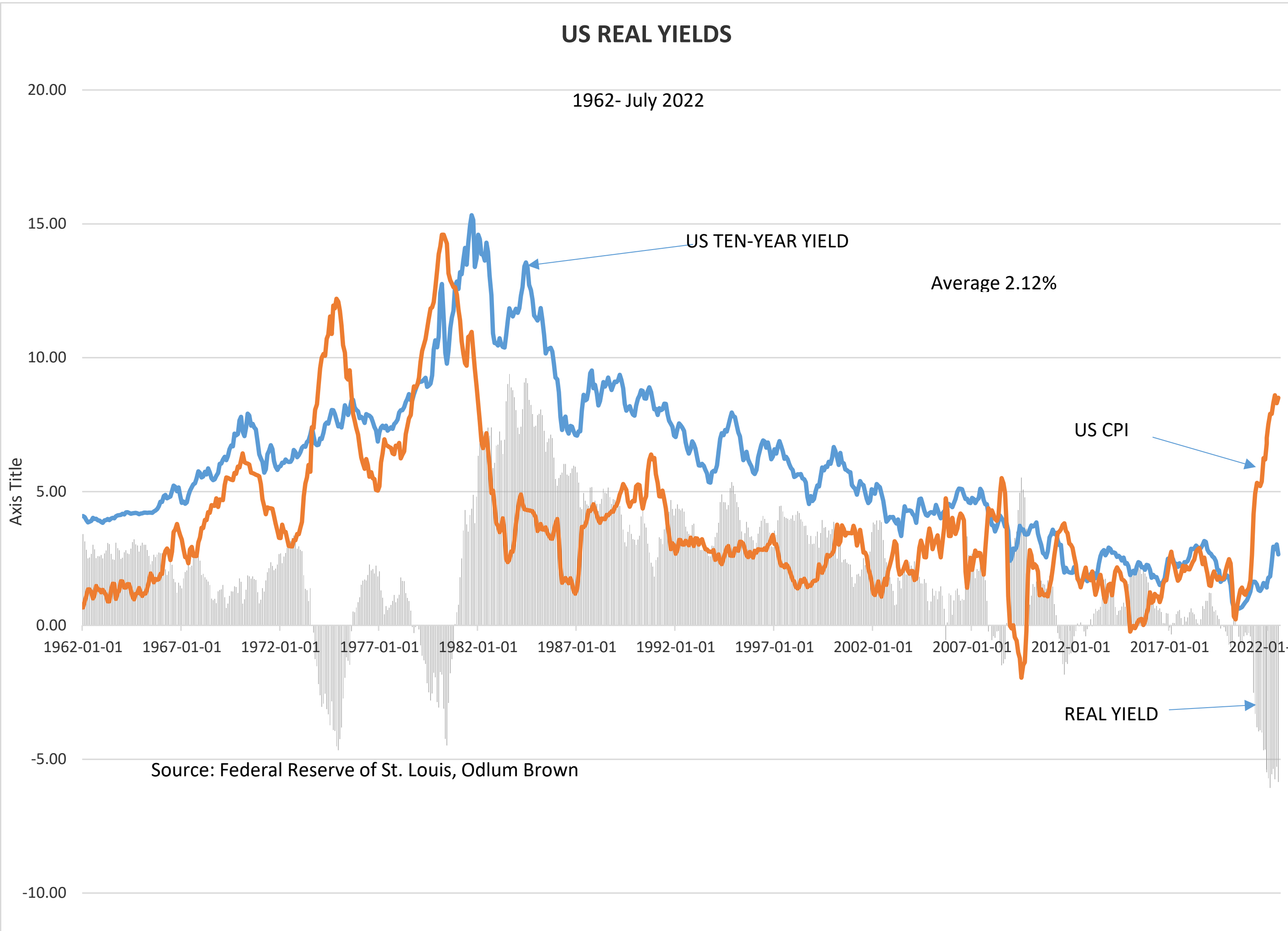
This bellwether's yield has been volatile, ranging from 3.50% to 2.50% and has settled at 2.75%. Recession forecasts have produced optimism in the bond market, even though inflation remains elevated.



Investment-grade corporate yields have declined with government yields. Spreads have been well behaved.



After experiencing week demand, high yield bonds have mounted a significant rally, with spreads narrowing to governemnt bonds. This behaviour is not typical of a recessionary environment.



The yield on fixed income securities remains significantly lower than the rate of inflation. This condition resulted from massive monetary stimulus from the Fed and most other central banks. Over the period from 1962 to the present, investors received over 2% (on average) above the rate of inflation. Eventually, the relationship between bond yields and inflation will be restored. We have just seen the first signs that inflation is beginning to ebb.

Outlook

The monetary tightening, only recently begun, is starting to impact economic growth prospects. In the U.S., GDP was negative for two consecutive quarters, accompanied by an inversion of the yield curve. These are traditional barometers of a recession. Global economic forecasts have tempered but are still positive. Housing markets have softened noticeably while commodity prices have endured a severe correction.

After the recent cooling in the CPI, speculation is rife that the Fed will only hike its rate by 50 basis points. It may be premature for such optimism, since the Fed is on record for wanting to see several consecutive months of improvement in inflation trends.

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.

We expect the U.S. 10-year Treasury yield range of 2.50% to 3.25% to persist. Corporate bond yields will track Treasury yields closely as credit conditions are still positive.

Wage pressures are escalating and have moved to the 5% level and may prevent the inflation rate from falling back to 2%. 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 the 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 geopolitical conflict. Already, the market has discounted several rate hikes and thus are not likely to react in a knee-jerk fashion. The Fed, and other central banks, remain committed to normalizing short-term interest rates in the belief that moving rates to the 3% area will not unduly affect economies.

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 further. 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.

The increase in corporate bond yields this year has resulted in a host of bonds, issued at lower yields, trading at significant discounts from their par values, thus creating positive after-tax opportunities.

We recommend a laddered approach using the **Odlum Brown Corporate Bond Ladder**. Also, we recommend individual floating-rate bonds. The Odlum Brown Model Portfolio is also well positioned for this market environment.

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.