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INVESTMENT RESEARCH

MONTHLY FIXED INCOME UPDATE

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December 13, 2022

Interest Rate Summary	Nov-30-22	Oct-31-22	Sep-29-22	Aug-31-22	Jul-29-22	Jun-30-22	May-31-22	Dec-31-21	Dec-31-20
U.S.									
3-Month T-Bill	4.35%	4.07%	3.30%	2.93%	2.36%	1.67%	1.06%	0.04%	0.08%
2-Year Treasury	4.31%	4.49%	4.28%	3.50%	2.89%	2.96%	2.56%	0.73%	0.12%
10-Year Treasury	3.61%	4.05%	3.83%	3.20%	2.65%	3.02%	2.85%	1.51%	0.92%
Canada									
3-Month T-Bill	3.99%	3.85%	3.78%	3.23%	2.65%	2.09%	1.47%	0.17%	0.06%
2-Year Canada	3.87%	3.89%	3.79%	3.65%	2.96%	3.09%	2.66%	0.95%	0.20%
10-Year Canada	2.94%	3.25%	3.17%	3.12%	2.61%	3.22%	2.89%	1.42%	0.68%

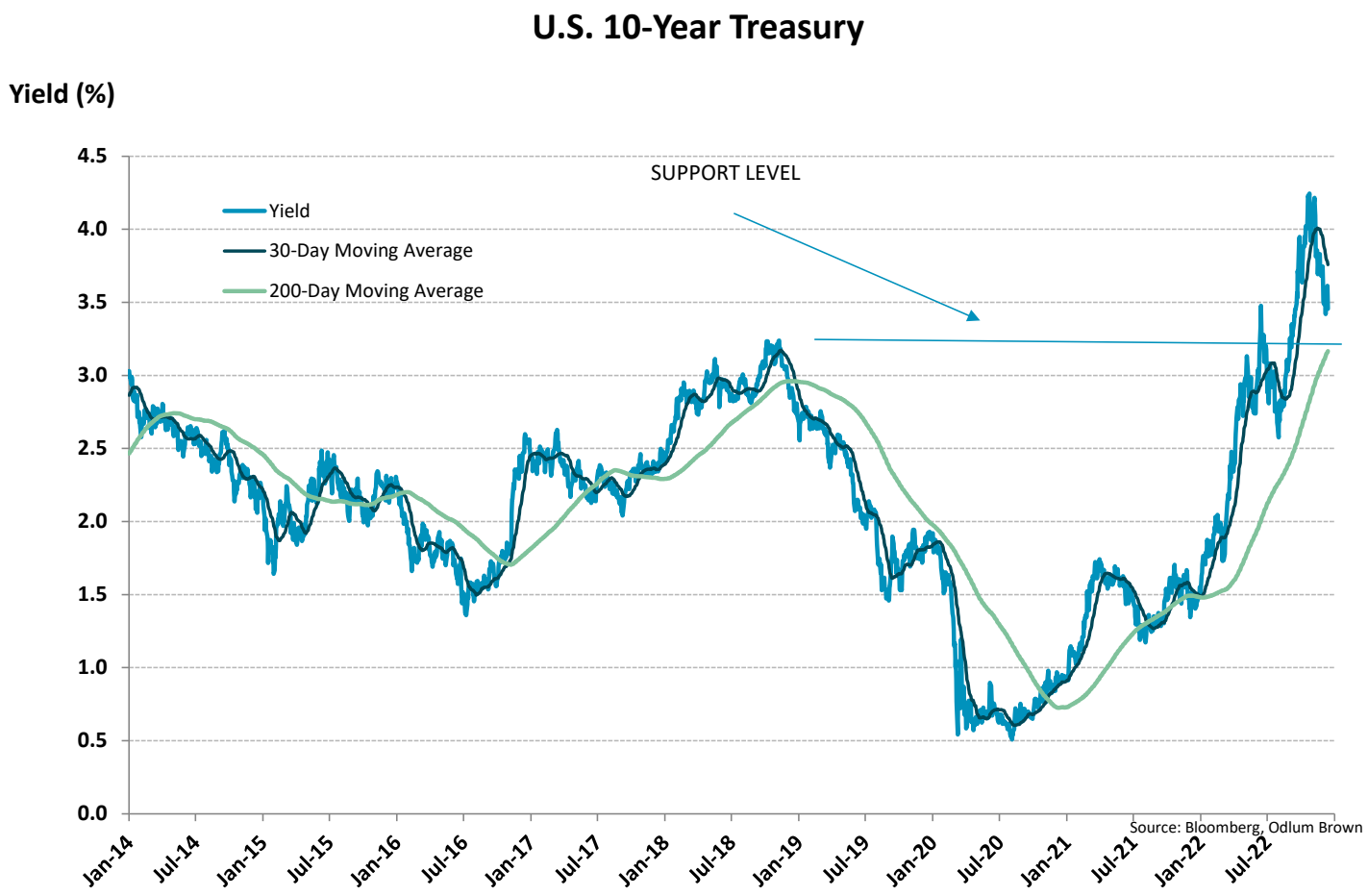
Performance	YTD	2021	2020	2019	2018	2017	2016
DEX Universe Bond Index	-10.20%	-2.54%	8.68%	6.87%	1.41%	2.52%	3.52%
DEX Federal Bond Index	-7.99%	-2.62%	7.28%	3.73%	2.39%	0.13%	3.66%
DEX Provincial Bond Index	-13.04%	-3.28%	9.86%	9.07%	0.66%	4.33%	4.14%
DEX All Corporate Index	-11.54%	-1.34%	8.74%	8.05%	1.10%	3.38%	2.71%
DEX "A" Corporate Index	-8.93%	-2.30%	8.98%	9.65%	0.51%	4.42%	2.62%
DEX Real Return Bonds	-13.79%	1.84%	13.02%	8.02%	-0.05%	0.72%	2.79%
DEX High Yield Bonds	-6.13%	6.18%	6.69%	8.48%	2.15%	5.20%	13.79%

Comments

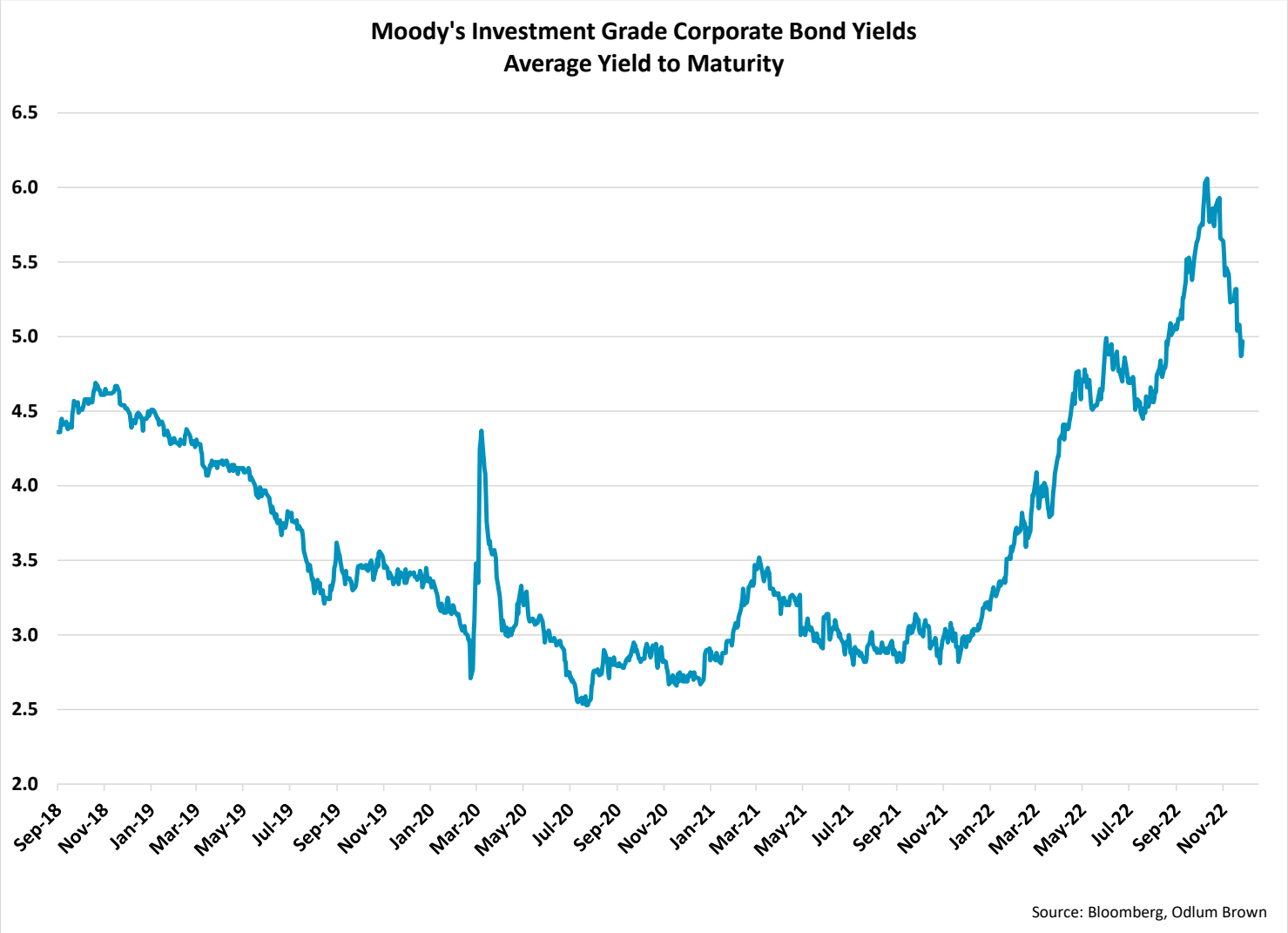
For only the second month this year, the bond market produced positive returns as most market yields fell. The chief catalyst for this was not difficult to uncover. Two consecutive softer-than-forecast prints provided relief on the inflation front, which sealed the Fed's decision to only raise its Funds Rate by 50 basis points on Dec 14. It also led to speculation that they would ease up the pace of increases in months ahead.

Recession watch continued this month. The yield curve, as measured by the spread between two-year and 10-year yields, reached its most inverted level since the 1980s. This measure has proved to be a reliable forecaster of recessions. While economic strength remained in some sectors of the U.S. economy, particularly the employment market, there have been signs of ebbing strength. However, the last two employment reports exceeded consensus estimates and wage growth also picked up.

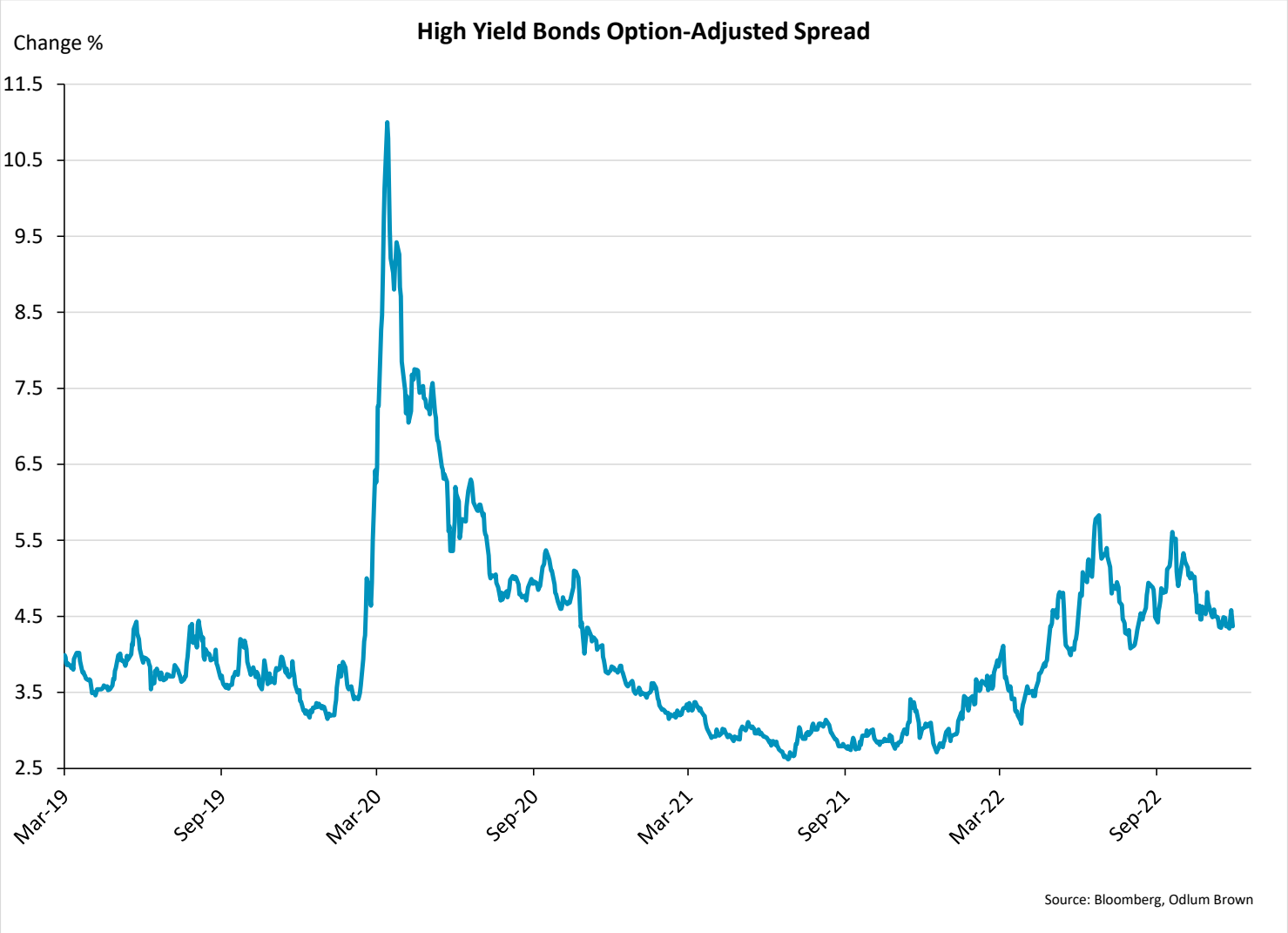
On balance, the yield on the two-year Treasury note fell by 26 basis points and the ten-year by 44 basis points to levels of 4.23% and 3.61%.They have fallen further since month-end. Corporate bonds, both high yield and investment grade, have remained relatively well-behaved.



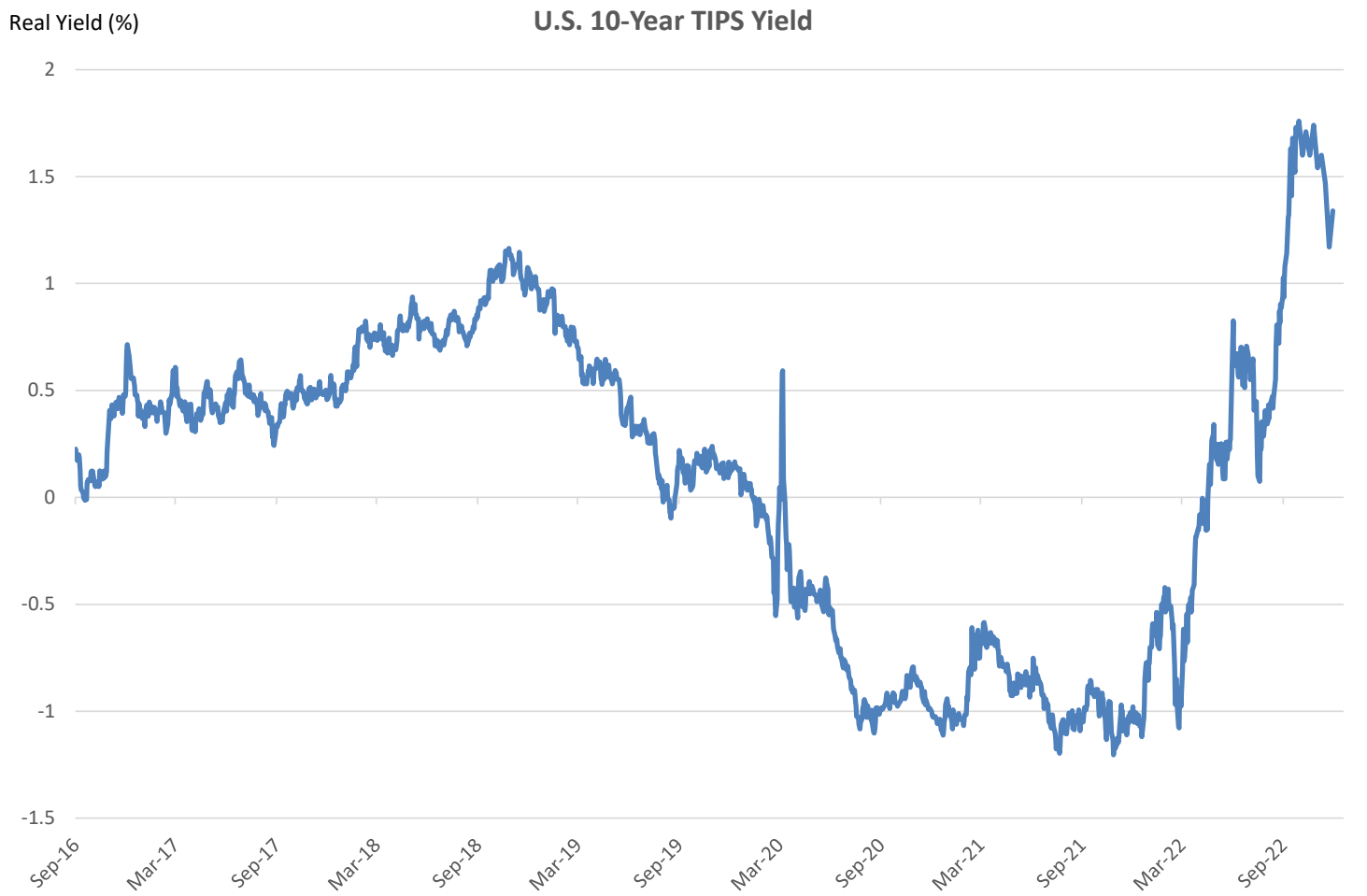
This bellwether's yield has been volatile reaching 4.25%, which is well above the previous resistance point of 3.25%. Its yield is 73 basis points less than the two-year note. This bond rallied sharply following improved CPI numbers and may have entered a new trading range of 3.25% to 4.25%.



Corporate bond markets remain calm. Investment-grade corporate yields have maintained a relatively steady spread from government bonds.



High yield bonds have performed well, with their spreads narrowing significantly from the summer peak.



Source: Bloomberg, Odlum Brown

After being mired in negative territory, real yields have responded to monetary tightening by moving higher. Recently, their yield has tracked lower with nominal yields.

Outlook

There is a growing, almost unanimous, consensus that inflation has peaked and will fall rapidly, leading to more declines in bond yields. The lagged effect of this year's seven increases in central bank lending rates has caused economic activity to ebb. Whether economies fall into recession is the big question and the answer is not yet clear.

It has been a grueling year for fixed income investors, one of the worst ever for performance. Next year should witness a return to positive performance, perhaps in the range of 4% to 6%. This outlook presumes a peaking in the central bank's tightening, and steady progress on the inflation front. To be sure, inflation remains in the forefront; however, wage increases could limit its improvement.

Central bank rates will stay elevated with no easing likely in all of 2023. The yield curve will remain inverted for the foreseeable future. In the meantime, fixed income investors can earn 5% or more on short-duration bonds, thus producing positive returns with minimal risk to principal.

In summary, global credit markets are discounting the next rounds of interest rate hikes, which removes the surprise factor and should result in few knee-jerk reactions. It is possible that several central banks reduce their bloated balance sheets via bond sales. The corporate bond market is a good place to look for signals that monetary tightening is beginning to affect credit quality.

Strategy

Inflation is the enemy of bonds and will remain a major negative for the foreseeable future. This continues to be a time to defend principal. We continue to advocate the use of floating-rate debentures, whose coupons are now above 5% and should remain there, as central banks are likely to pause. In combination with a one- to five-year corporate ladder, returns should be positive.

This year's increase in corporate yields 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 have created the **Odlum Brown Discount Corporate Ladder** portfolio to take advantage of this opportunity.

We are approaching the time when the end of the monetary-tightening cycle may occur, producing a peak Fed Funds Rate of at least 5%. Thus, this is a time when some modest increase in duration may be in order, which can be achieved by adding three- to five-year bonds to existing ladders.

We also continue to recommend a laddered approach using the **Odlum Brown Corporate Bond Ladder**, which features more in the way of current coupon bonds. Also, we recommend individual floating-rate bonds. The **Odlum Brown Model Portfolio** is well positioned for this market environment with a 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.