Monthly Fixed Income Update

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February 13, 2024

Interest Rate Summary	Jan-31-24	Dec-29-23	Nov-30-23	Oct 31-23	Sep 29-23	Aug 31-23	Jul 31-23	Jun 30-23	May 31-23
U.S.									
3-Month T-Bill	5.37%	5.34%	5.39%	5.47%	5.45%	5.45%	5.42%	5.30%	5.40%
2-Yr Treasury	4.21%	4.25%	4.68%	5.09%	5.05%	4.87%	4.88%	4.90%	4.41%
10-Yr Treasury	3.91%	3.88%	4.33%	4.93%	4.57%	4.11%	3.96%	3.84%	3.65%
Canada									
3-Month T-Bill	5.00%	5.04%	5.02%	5.02%	5.11%	5.12%	5.04%	4.91%	4.64%
2-Year Canada	3.97%	3.89%	4.19%	4.64%	4.87%	4.64%	4.67%	4.58%	4.22%
10-Year Canada	3.32%	3.11%	3.55%	4.06%	4.02%	3.56%	3.50%	3.27%	3.19%

Performance	YTD*	2023	2022	2021	2020	2019	2018
DEX Universe Bond Index	-3.01%	6.69%	-11.69%	-2.54%	8.68%	6.87%	1.41%
DEX Federal Bond Index	-2.77%	5.00%	-9.34%	-2.62%	7.28%	3.73%	2.39%
DEX Provincial Bond Index	-4.11%	7.31%	-15.05%	-3.28%	9.86%	9.07%	0.66%
DEX All Corporate Index	-1.85%	8.37%	-11.54%	-1.34%	8.74%	8.05%	1.10%
DEX "A" Corporate Index	-2.05%	8.23%	-9.87%	-2.30%	8.98%	9.65%	0.51%
DEX Real Return Bonds	-5.01%	1.99%	-14.32%	1.84%	13.02%	8.02%	-0.05%
DEX High Yield Bonds	0.81%	10.00%	-5.44%	6.18%	6.69%	8.48%	2.15%

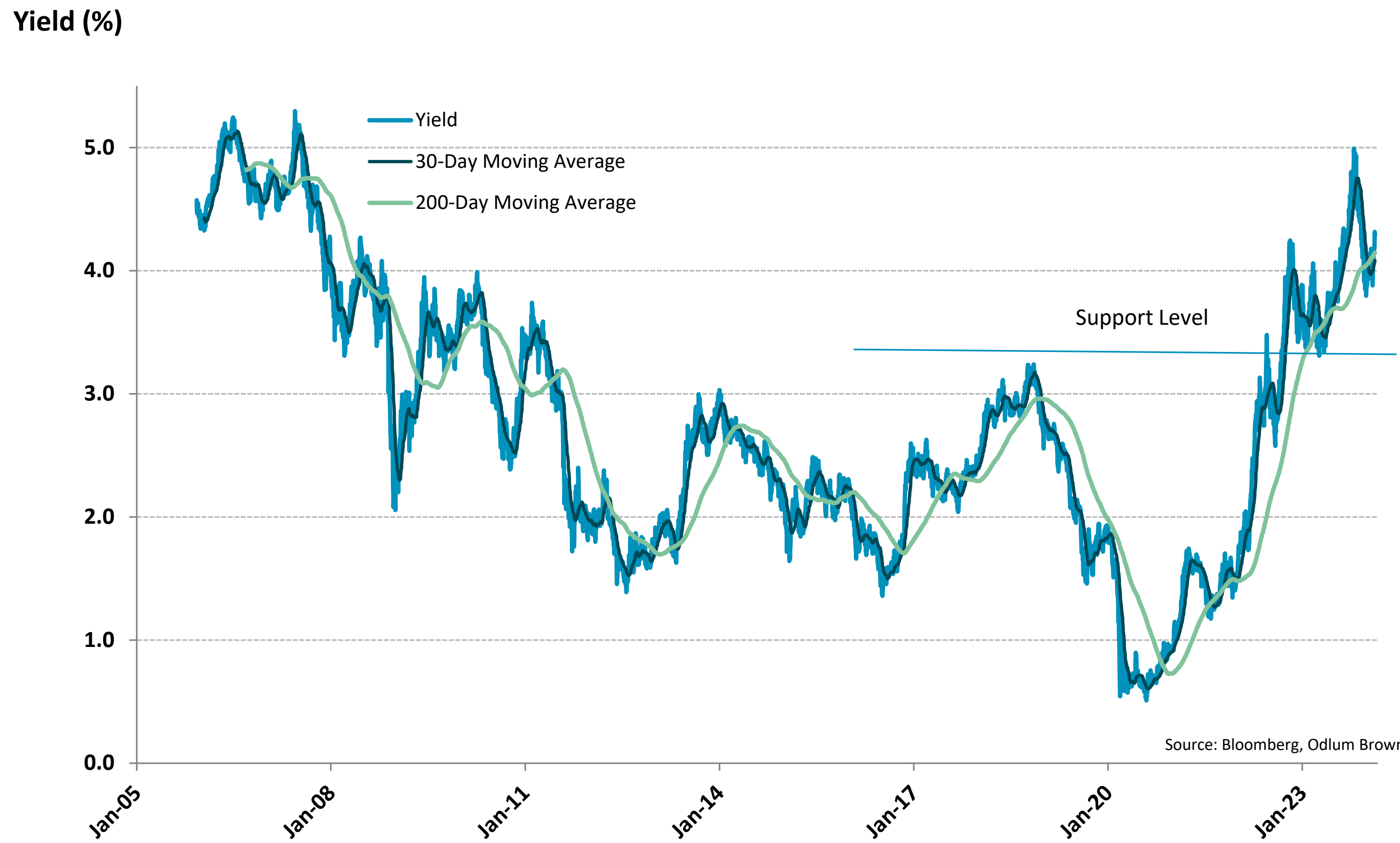
** As of February 13, 2024*

Comments

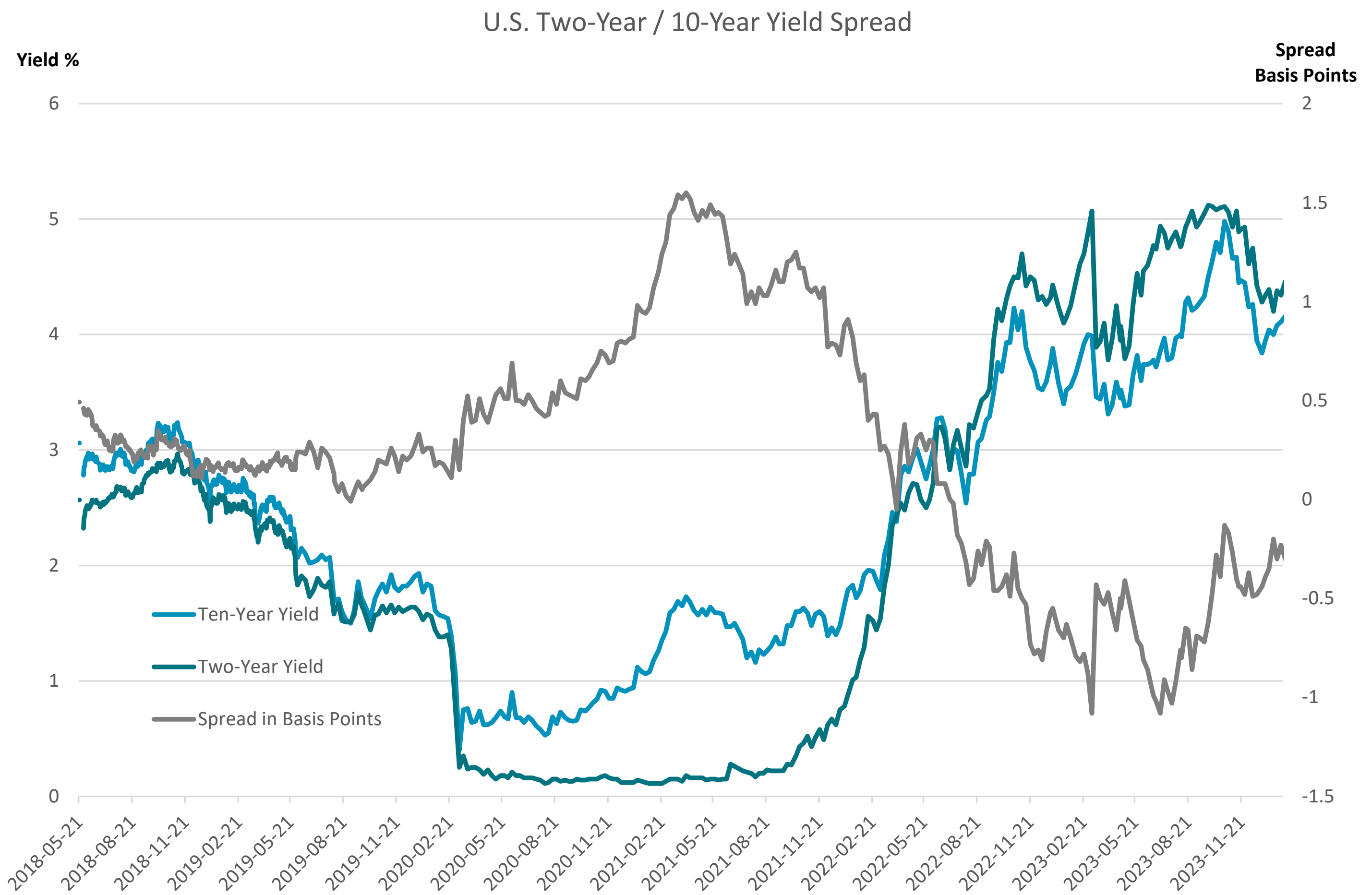
Following the dramatic year-end rally in the bond market, 2024 began with yields reversing direction to close the month of January unchanged. Thus far in February, bond yields have climbed, with the 10-year U.S. Treasury note touching 4.31%.

On January 31, the Federal Reserve Open Market Committee (FOMC) voted to leave the Fed Funds rate unchanged. Fed Chair Powell made it clear that the FOMC was in no hurry to lower rates, effectively dashing hopes for a March reduction. Since then, a string of fresh economic data has underscored the resilience in the economy, making the case more difficult for further easing of inflationary pressures. This was borne out by the recent CPI release in the U.S., displaying an uptick in all categories. Despite signs of a cooling economy, corporate bond spreads, both investment-grade and high yield, remained near their tightest of the year. Also, thus far, the market has easily absorbed the massive U.S. Treasury bond issuance.

U.S. 10-Year Treasury

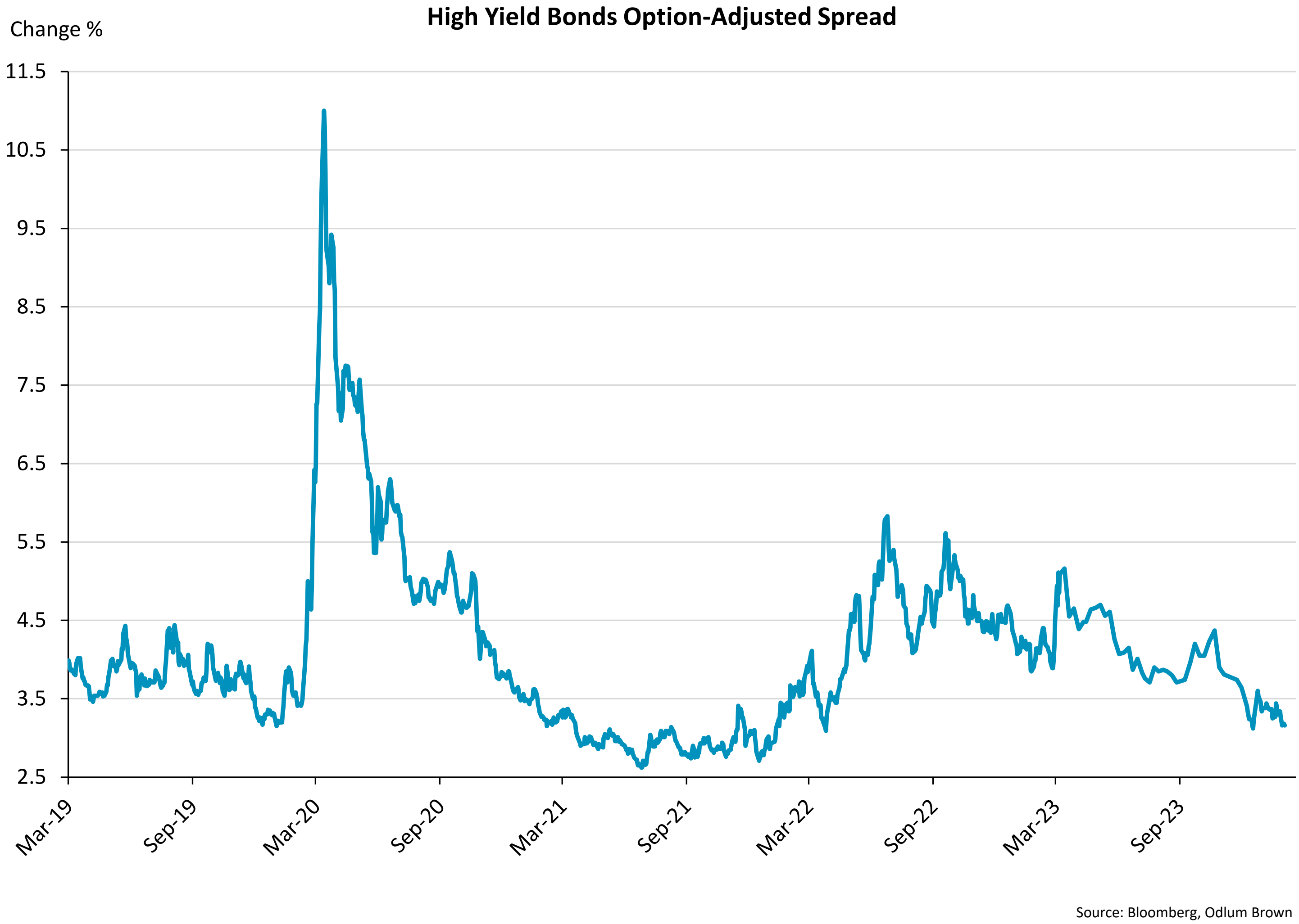


After reaching a 16-year high of 5%, this bond plunged to 3.88%, but has since soared well above its 200-day moving average to 4.30%



Source: Bloomberg, Odlum Brown

The yield curve remains inverted but has moved closer to a positive position.



High yield bond spreads remain near their lows for the past year.

Outlook

The resilience of the U.S. economy has prompted the FOMC to maintain its monetary stance for now. While it has stated that three rate reductions are possible this year, the timing of those has been pushed out. The recent CPI report underscores inflation's stickiness, meaning a rate reduction could be counterproductive. What is more probable is a gradual reduction, with the Fed Funds rate likely to move 50 to 75 basis points lower towards the end of the year.

A similar scenario is unfolding in Canada after GDP growth picked up at the end of 2023, putting the Bank of Canada on the sidelines.

Inflation remains the key fundamental for the bond market outlook. With the recent economic strength, accompanied by escalating wages, it will likely prove difficult to reach the avowed 2% inflation target. Should that prove to be the case, it stands to reason that longer-term bond yields will rise. This also reflects the massive borrowing requirements as there is no attempt to rein in federal deficits. In addition, the Federal Reserve is still engaged in quantitative tightening.

The net effect will be an eventual return to a positive yield curve with short- and mid-term yields falling below longer-term yields.

Strategy

We may have reached the end of the monetary tightening cycle. It is not a given as central banks remain laser-focused on inflation. However, it is likely that the yield curve will reflect the economic reality by eventually normalizing. Also, the Fed and other central banks will be loathed to prematurely abandon their hard-fought gains against inflation. The lagged effect of monetary tightening is now being felt.

Last month we concluded that it might be timely to extend duration in fixed income portfolios. After the somewhat hawkish comments by the Federal Reserve on January 31, followed by a surprisingly bearish CPI report, we no longer recommend an extension in duration. Fixed income investors should favour one- to three-year maturities. Given the tight spreads between corporate and government issues, we prefer government bonds, especially provincial bonds. The after-tax appeal for discount government and corporate bonds remains attractive.

We continue to advocate the use of floating-rate debentures for now, whose coupons should remain well above 5% even if central banks pause, in combination with a one- to five-year ladder of high-quality corporate and provincial bonds. The net result is a short-duration, high-yielding portfolio. We have recommended adding federal and provincial bonds to portfolios to enhance liquidity and credit quality in the event of stress in corporate credit.

This year's increase in yields has caused bonds issued at lower yields to trade at deep discounts to their par values. These bonds 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.

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.