Monthly Fixed Income Update

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Interest Rate Summary	Dec-29-23	Nov-30-23	Oct 31-23	Sep 29-23	Aug 31-23	Jul 31-23	Jun 30-23	May 31-23	Apr 28-23
U.S.									
3-Month T-Bill	5.34%	5.39%	5.47%	5.45%	5.45%	5.42%	5.30%	5.40%	5.06%
2-Yr Treasury	4.25%	4.68%	5.09%	5.05%	4.87%	4.88%	4.90%	4.41%	4.00%
10-Yr Treasury	3.88%	4.33%	4.93%	4.57%	4.11%	3.96%	3.84%	3.65%	3.43%
Canada									
3-Month T-Bill	5.04%	5.02%	5.02%	5.11%	5.12%	5.04%	4.91%	4.64%	4.43%
2-Year Canada	3.89%	4.19%	4.64%	4.87%	4.64%	4.67%	4.58%	4.22%	3.65%
10-Year Canada	3.11%	3.55%	4.06%	4.02%	3.56%	3.50%	3.27%	3.19%	2.84%

Performance	2023	2022	2021	2020	2019	2018	2017
DEX Universe Bond Index	6.69%	-11.69%	-2.54%	8.68%	6.87%	1.41%	2.52%
DEX Federal Bond Index	5.00%	-9.34%	-2.62%	7.28%	3.73%	2.39%	0.13%
DEX Provincial Bond Index	7.31%	-15.05%	-3.28%	9.86%	9.07%	0.66%	4.33%
DEX All Corporate Index	8.37%	-11.54%	-1.34%	8.74%	8.05%	1.10%	3.38%
DEX "A" Corporate Index	8.23%	-9.87%	-2.30%	8.98%	9.65%	0.51%	4.42%
DEX Real Return Bonds	1.99%	-14.32%	1.84%	13.02%	8.02%	-0.05%	0.72%
DEX High Yield Bonds	10.00%	-5.44%	6.18%	6.69%	8.48%	2.15%	5.20%

Comments

After peaking at 5% on October 19, the U.S. 10-year note mounted a spectacular rally, ending October at 4.93%, closing November at 4.33% and yielding 3.88% by year's end. Thus, the 10-year yield has come full circle, closing the year almost where it began. This was one of the biggest rallies in bond market history over a short period. Yields have since moved higher to 4.10% currently.

Two factors were driving this rally: a cooling economy and moderating inflation. This market enthusiasm arose since traders believed that not only was the Fed finished tightening but that it would also signal an ease in its heretofore hawkish stance. On December 13, the markets got their wish as the Fed emerged from its FOMC meeting with unexpected dovish comments, indicating that it was likely done tightening and that it foresaw three reductions in the Fed Funds Rate in 2024. The bond market soared with yields falling all along the yield curve. Canadian yields followed with our 10-year bond hitting 3.20%.

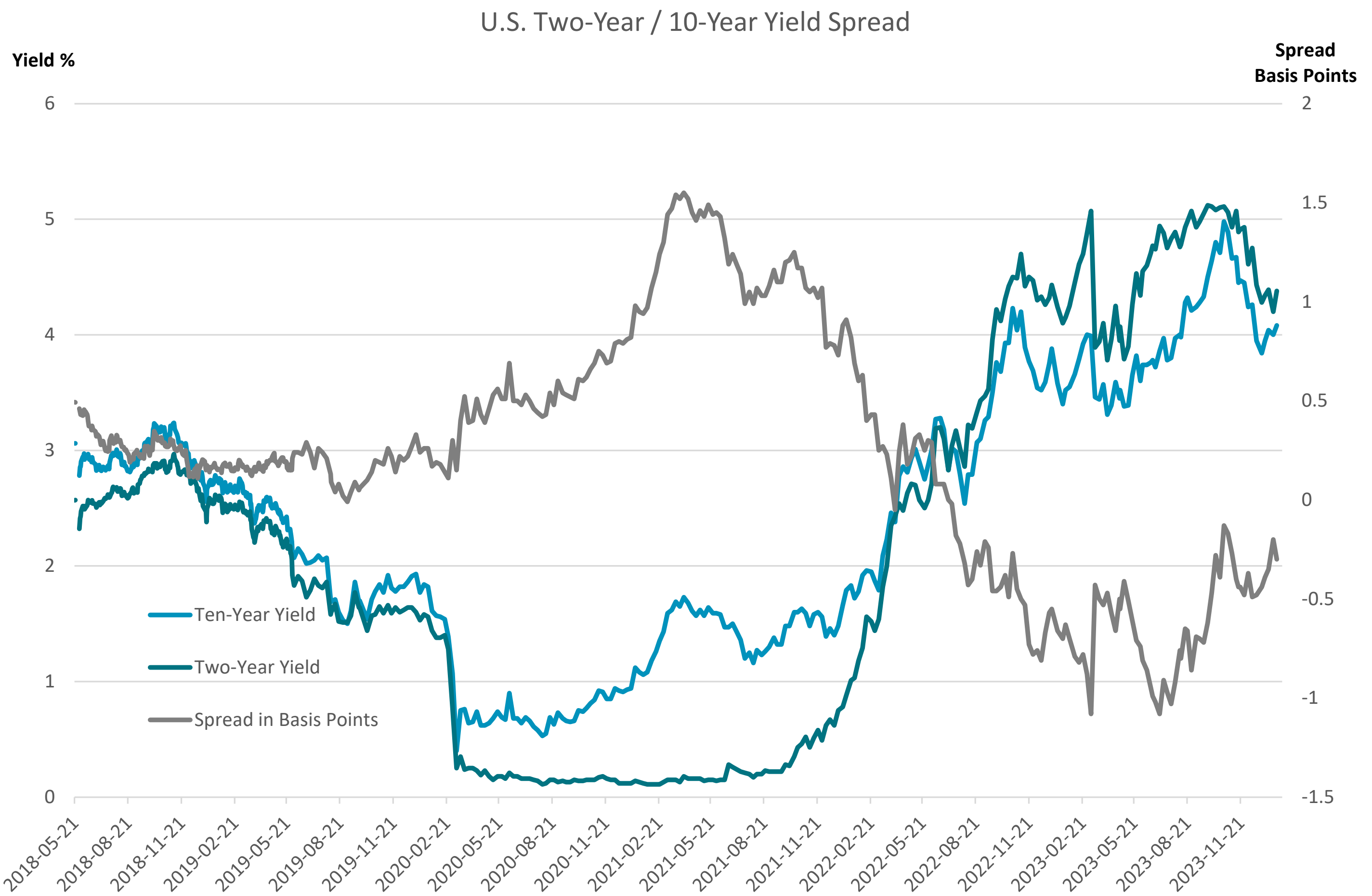
Further buttressing this rally was the Bank of Japan's decision to not tighten monetary policy, as had been widely feared.

Despite signs of a cooling economy, corporate bond spreads, both investment-grade and high-yield, remained near their tightest spreads of the year. The dramatic decline in American yields led to a selloff in the U.S. dollar and the loonie has advanced as a result.

U.S. 10-Year Treasury

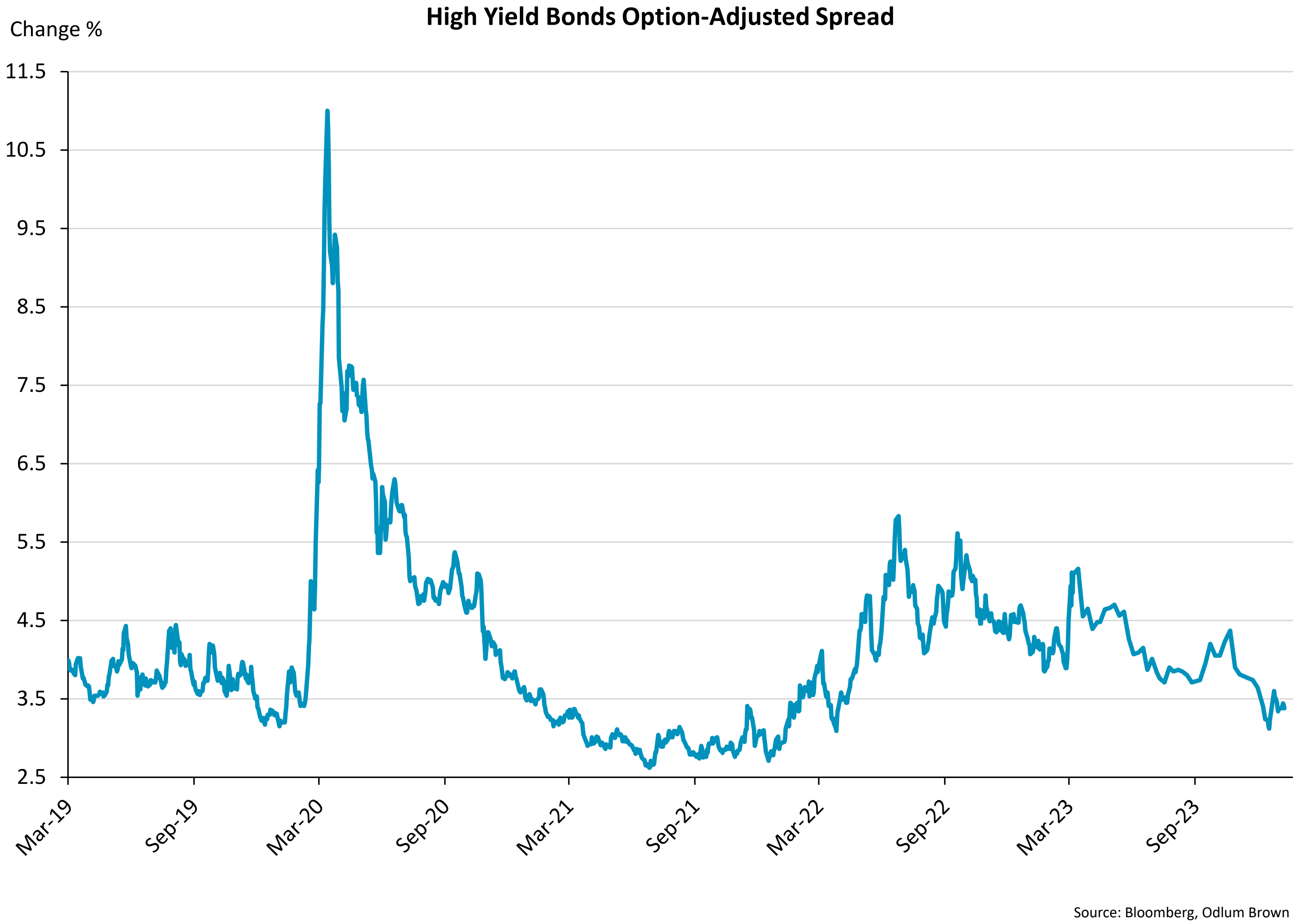
Source: Bloomberg, Odlum Brown

After reaching a 16-year high of 5%, this bond plunged to 3.88% but has since risen above its 200-day moving average to 4.10%



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 bond market rallied further after the recent dovish comments from the U.S. Federal Reserve, pushing yields lower at all maturities. Several Fed officials have been quick to douse the market enthusiasm for near-term reductions in the Federal Funds rate, conditioning investors to be patient. Too early a reduction could be counterproductive to its inflation fight. What is more probable is a gradual move to lower rates with the Fed Funds rate likely to settle in the 3%-4% level.

Importantly, while inflation has steadily improved, it is becoming sticky around 3% and expectations have inched higher. Also, the labour market remains healthy with the unemployment rate low and as wage growth has moved to 4%. Belying recession forecasts, corporate bond spreads remain tight to government bonds.

Besides this, the bond market must deal with not only the tsunami of U.S. Treasury bond issuances to fund the deficit but also ongoing quantitative tightening.

This argues against further declines in bond yields, especially long-term bonds. At 4.1%, the U.S. 10-year offers investors no premium over inflation and may not fall in yield from here. It could possibly move higher.

The net effect will be an eventual return to a positive yield curve with 3% as its base and the two- to six-year maturities falling below the 10-year and longer.

The Bank of Canada faces a weaker economy than the Fed, and it would like to begin to reduce its bank rate but is being restrained by stubborn inflation and strong wage increases. Our mid-term rates should follow those of the U.S., thus permitting some badly needed relief in mortgage costs.

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 normalizing. Also, the Fed and other central banks will be loathed to abandon their hard-fought gains against inflation prematurely. The lagged effect of monetary tightening is now being felt.

Last month we asked if it was the right time to extend duration. It is an important question. We believe the answer is yes for the Canadian bond market as our economy has stalled and the Bank of Canada's pause will likely continue despite its hawkish rhetoric. It may introduce a more dovish stance should the economy weaken further. Fixed income investors should consider moving further out the yield curve, to a maximum term of five years, with a duration of two to three years.

We continue to advocate the use of floating-rate debentures for now. Those 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 some stress appearing 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 a number of 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.