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INVESTMENT RESEARCH

Monthly Fixed Income Update

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Interest Rate Summary	May-31-21	Apr-30-21	Mar-31-21	Feb-27-21	Jan-29-21	Dec-31-20	Dec-31-19	Dec-31-18
U.S.								
3-Month T-Bill	0.01%	0.01%	0.02%	0.04%	0.05%	0.08%	1.55%	2.36%
2-Year Treasury	0.14%	0.16%	0.16%	0.13%	0.11%	0.12%	1.57%	2.49%
10-Year Treasury	1.60%	1.63%	1.74%	1.41%	1.07%	0.92%	1.92%	2.69%
Canada								
3-Month T-Bill	0.11%	0.10%	0.08%	0.06%	0.06%	0.06%	1.65%	1.64%
2-Year Canada	0.32%	0.30%	0.22%	0.15%	0.15%	0.20%	1.69%	1.86%
10-Year Canada	1.48%	1.54%	1.56%	1.35%	0.89%	0.68%	1.70%	1.97%

Performance

	YTD	2020	2019	2018	2017	2016	2015
DEX Universe Bond Index	-4.38%	8.68%	6.87%	1.41%	2.52%	3.52%	3.52%
DEX Federal Bond Index	-3.45%	7.28%	3.73%	2.39%	0.13%	3.66%	3.66%
DEX Provincial Bond Index	-6.14%	9.86%	9.07%	0.66%	4.33%	4.14%	4.14%
DEX All Corporate Index	-3.01%	8.74%	8.05%	1.10%	3.38%	2.71%	2.71%
DEX “A” Corporate Index	-4.33%	8.98%	9.65%	0.51%	4.42%	2.62%	2.62%
DEX Real Return Bonds	-5.60%	13.02%	8.02%	-0.05%	0.72%	2.79%	2.79%
DEX High Yield Bonds	3.95%	6.69%	8.48%	2.15%	5.20%	13.79%	-5.58%

After experiencing rising yields in the first three months of the year and accompanying negative performance, the bond market turned in mostly positive performance in May. Government bonds showed mildly positive results, with most corporate bond sectors outperforming the government sector. Real Return bonds bounced back as well.

The bond market continued to consolidate in May as the U.S. ten-year yield fell by three basis points, and fell a further 10 basis points since month-end. Year-to-date, this bond has added 58 basis points to yield 1.50%. With the two-year yield at 0.15%, the yield curve has flattened modestly to 135 basis points.

Fed Chair Powell remained steadfast in his loose monetary stance, continuing to buy $120 billion of bonds and mortgages per month, and stating repeatedly that he expects any run-up in inflation to be transitory. His views and stance have helped to calm the bond market.

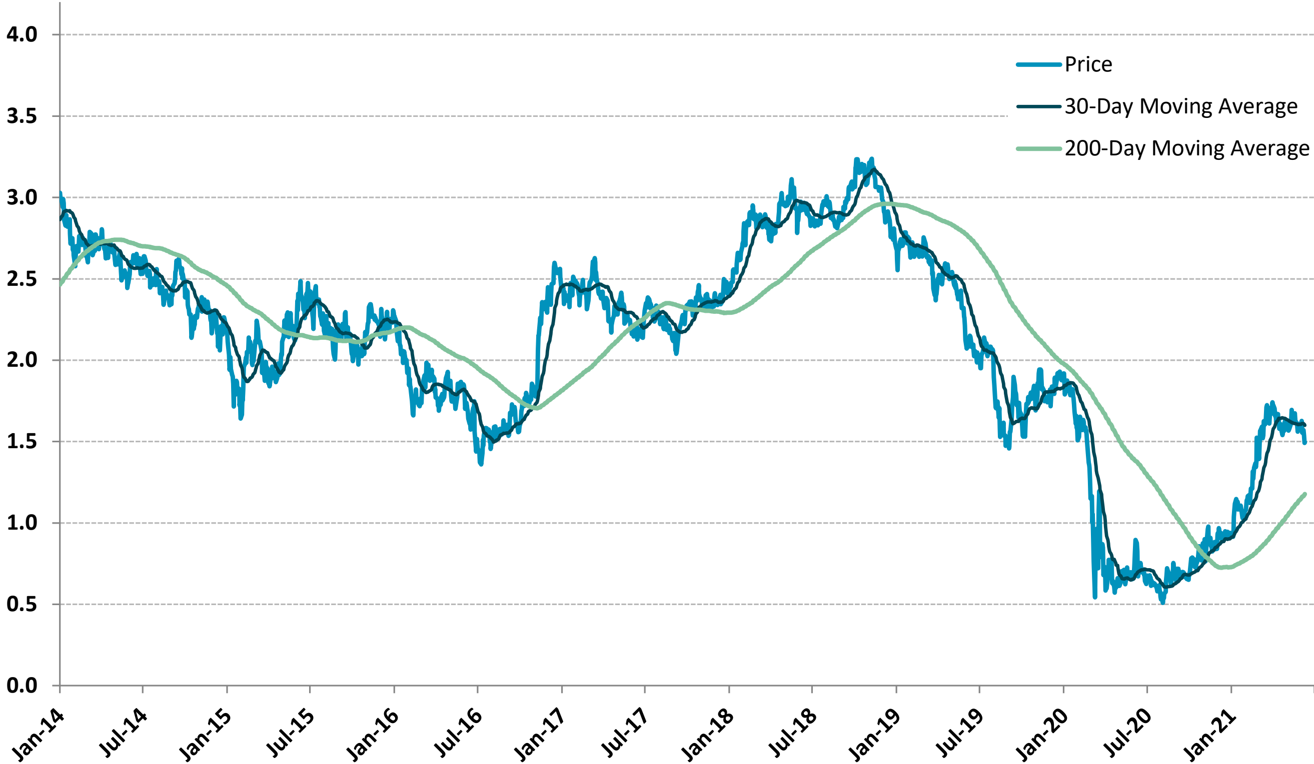
Meanwhile, the economic recovery continued to accelerate with key indicators such as PMIs, ISM manufacturing, GDP and personal income all showing solid growth. This latter number was a blockbuster. Retail sales, however, were flat.

The employment market gave mixed signals. In March, the U.S. economy added almost one million jobs; however, the market was shocked when, with similar forecasts for April, the economy added just 200,000 jobs and May showed a gain of only 559,000, again below consensus. This has helped to suppress bond yields and pushed back forecasts of Fed tapering.

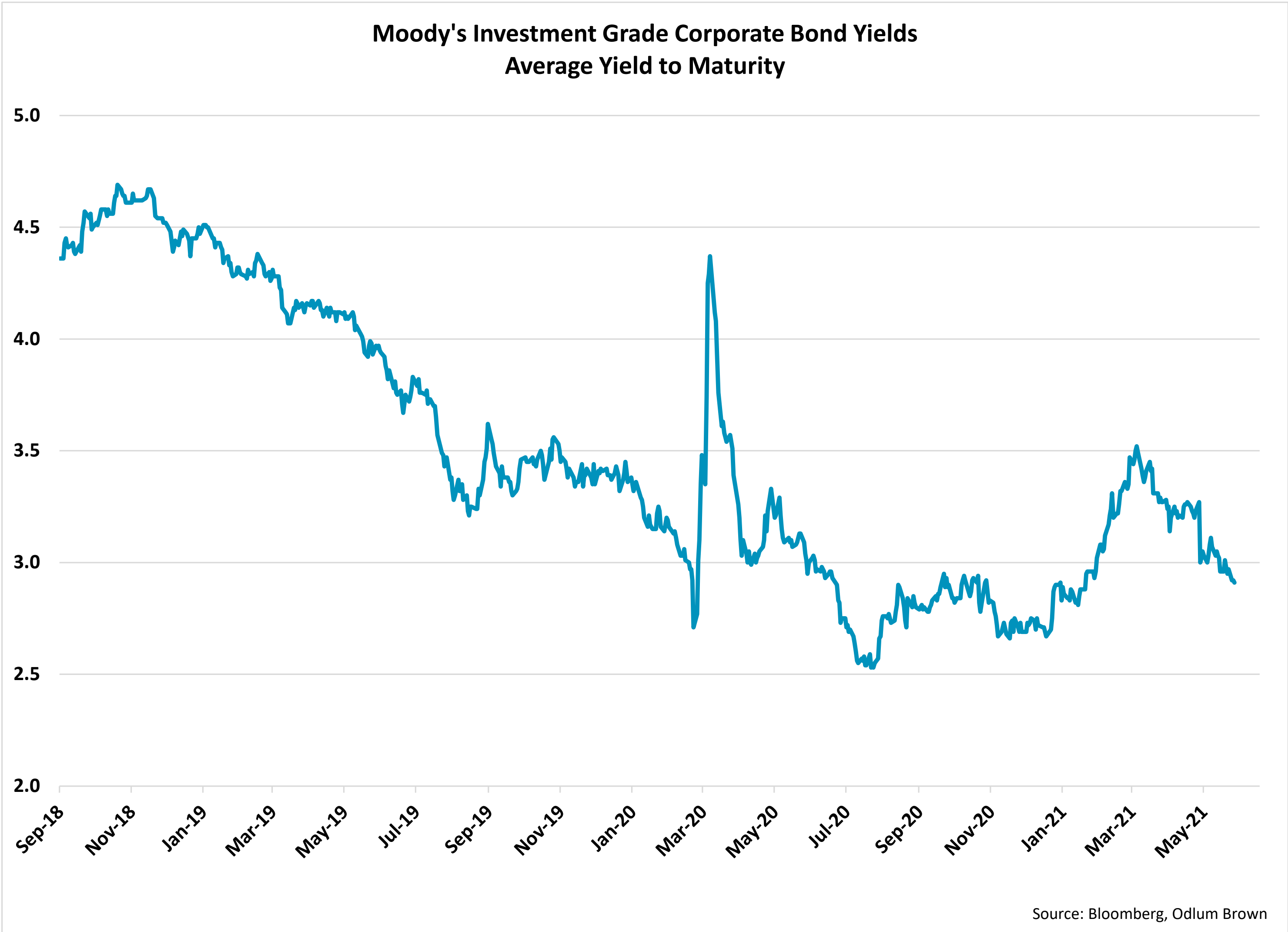
Canada reported a string of positive data, including the eleventh consecutive monthly gain in GDP. Unfortunately, our employment market experienced the same disappointing results as in the U.S. The Bank of Canada, noting the solid ongoing growth, became the first central bank in the developed world to reduce monetary accommodation by tapering its bond purchases. With subsequent weakness as a result of forced pandemic shutdowns, the Bank of Canada paused its tapering stance. Also, Canada recorded its first current account surplus since 2008.

The two most recent Consumer Price Index reports in the U.S. surprised pundits on the upside, reflecting surging commodity prices and enhanced pricing power for corporations. Core inflation is now running at 3.8% annualized, the most since 1991. There is a chorus of Fed officials, along with the Secretary of the Treasury, all invoking the transitory argument. The Fed is doing everything to avoid another “taper tantrum” as occurred in 2013.

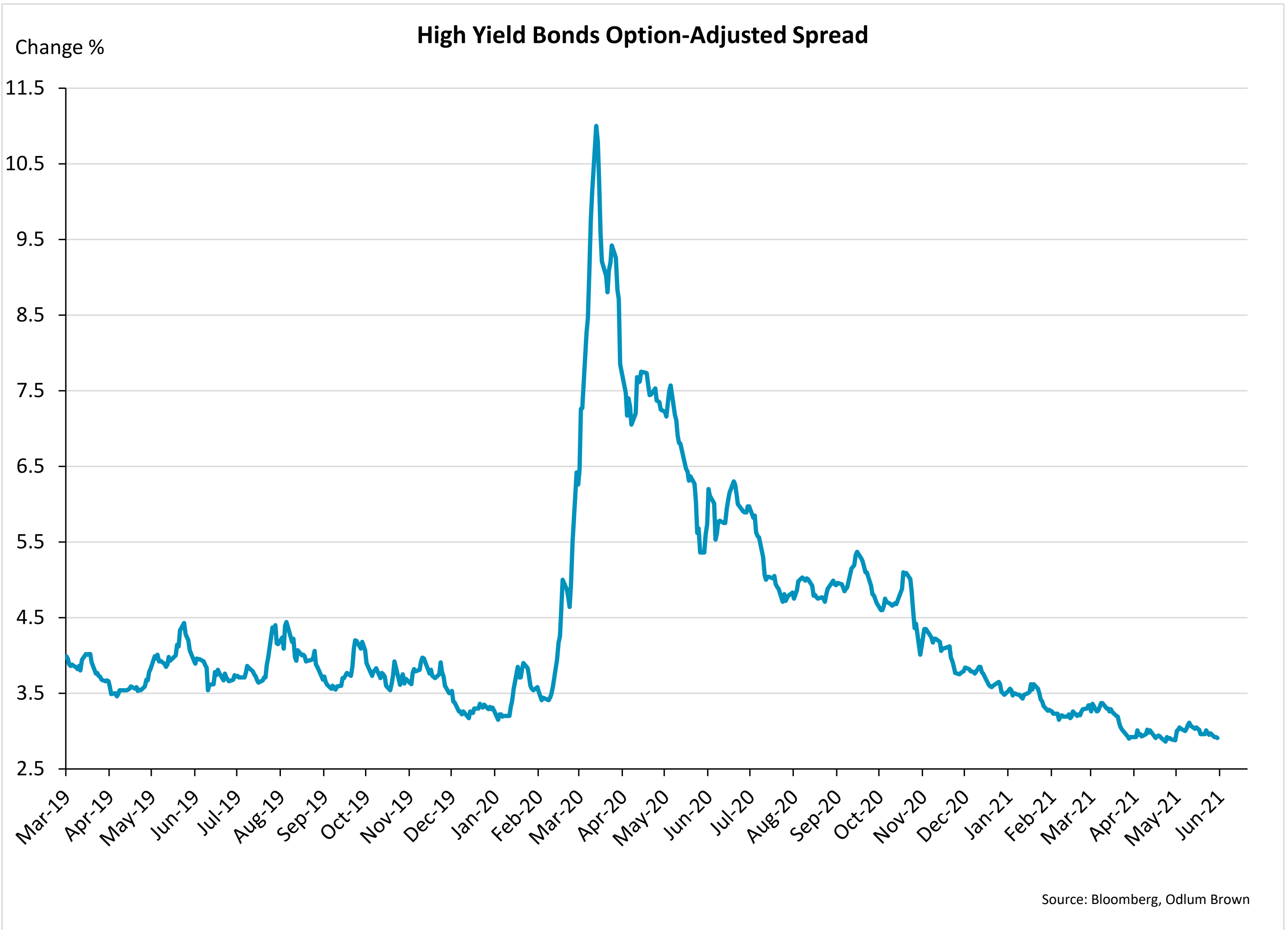
Europe’s economy is rebounding strongly, as witnessed by the record increase in PMIs. China is also recording higher inflation.



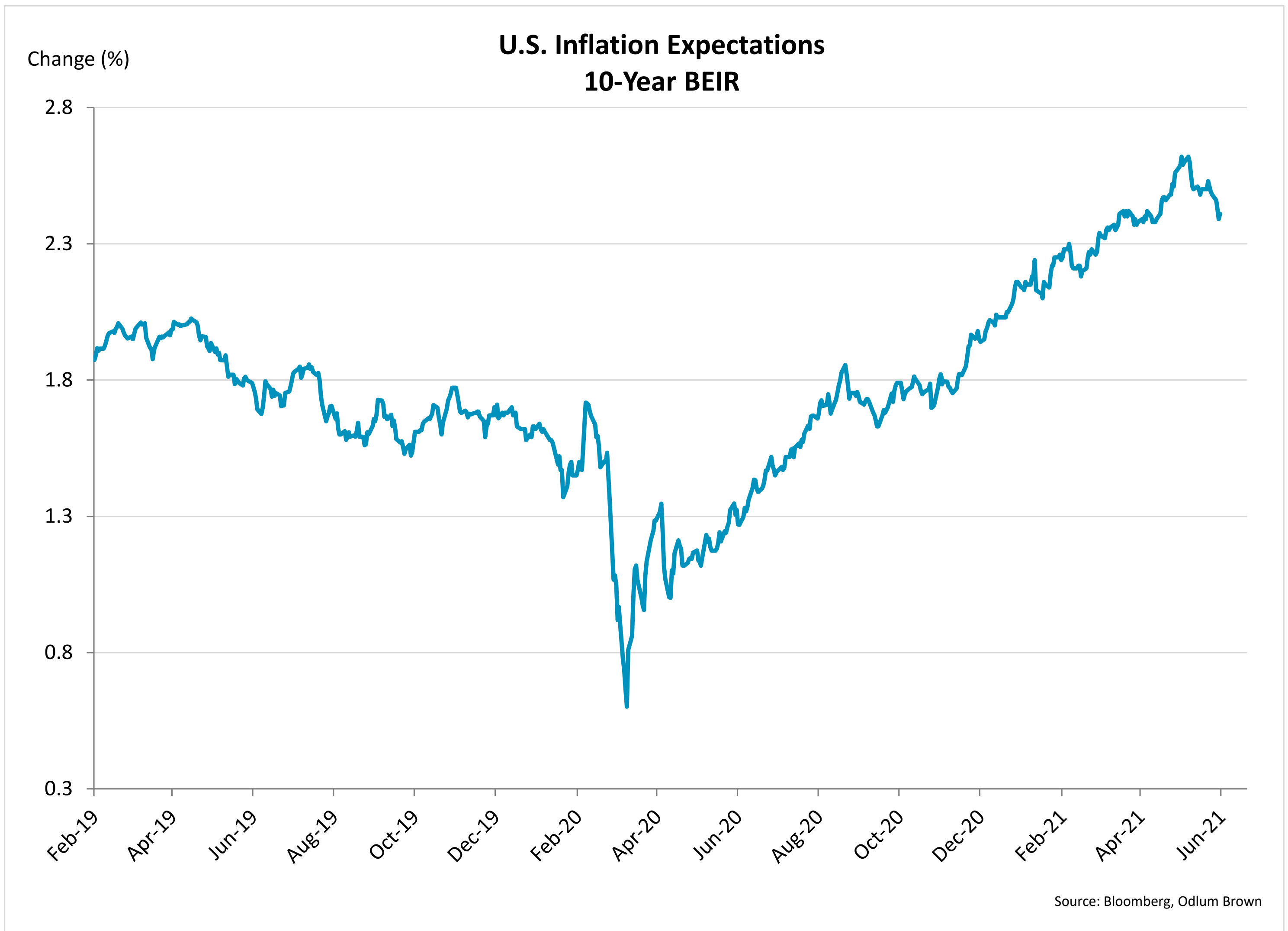
This global bellwether moved decisively higher in yield during the first three months of 2021, but has moved lower to levels last seen in February 2020.



Investment-grade corporate bond yields began to move higher with U.S. Treasury yields and are tracking them again as Treasury yields move lower.



The high yield market remains close to record low spreads.



Inflation expectations moved steadily lower.

Outlook

There is a great divide in inflation forecasting. A large contingent of forecasters, led by the Fed and the Treasury Secretary, believe the current pickup in inflation is transitory and that it will subside after the long-term deflationary factors such as demographics, technological advancements and debt kick in. Another camp views the combination of massive monetary and fiscal accommodation, along with a tight employment market and rising wages, as a cyclical phenomenon and one which will produce higher yields.

The Fed, despite its transitory stance, is tip-toeing towards the first reduction in its bond-buying program. No less than five Fed officials have been quietly espousing a move towards tapering and it was likely discussed at the recent FOMC meeting. Chair Powell will proceed cautiously.

The economic recovery will continue to accelerate and move past pre-pandemic growth levels. It is difficult to see how bond yields can fall from current levels with the ten-year yield substantially below the inflation rate. The recent fall in bond yields may be one more example of "not fighting the Fed."

At the margin, bonds are expensive and their yields could creep higher, with 2% as a target on the U.S. 10-year Treasury. Credit markets remain healthy. Investors can look forward to modest positive returns.

Strategy

With an outlook for mild increases in bond yields, the priority for fixed income investors remains the preservation of capital. We continue to stress the importance of including high-quality, fixed income securities of relatively short durations in client portfolios. In this environment, we favour non-cyclical corporate bonds of maturities less than five years, such as those issued by utilities, banks, telecommunications and recurring-revenue businesses. Corporate bonds will generate only modest returns at best this year but will outperform government bonds. We have long recommended a laddered approach to fixed income investing. We continue to do so, and suggest a one- to five-year ladder for a shorter duration.

For several years, we have had an approved list of outside fund managers. At present, in order to augment returns and benefit from their expertise in credit markets, we recommend two of these managers in particular, who are well positioned for this market environment. For further discussion, please speak to your Portfolio Manager or Investment Advisor.

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