Monthly Fixed Income Update

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Interest Rate Summary	May-31-22	Apr-29-22	Mar-31-22	Feb-28-22	Jan-31-22	Dec-31-21	Nov-30-21	Oct-29-21	Dec-31-20
U.S.									
3-Month T-Bill	1.06%	0.83%	0.50%	0.31%	0.19%	0.04%	0.05%	0.05%	0.08%
2-Year Treasury	2.56%	2.72%	2.34%	1.43%	1.16%	0.73%	0.57%	0.50%	0.12%
10-Year Treasury	2.85%	2.94%	2.34%	1.83%	1.77%	1.51%	1.45%	1.56%	0.92%
Canada									
3-Month T-Bill	1.47%	1.44%	0.73%	0.57%	0.34%	0.17%	0.06%	0.15%	0.06%
2-Year Canada	2.66%	2.62%	2.29%	1.43%	1.25%	0.95%	0.98%	1.09%	0.20%
10-Year Canada	2.89%	2.86%	2.40%	1.81%	1.77%	1.42%	1.57%	1.72%	0.68%

Performance	YTD	2021	2020	2019	2018	2017	2016
DEX Universe Bond Index	-10.28%	-2.54%	8.68%	6.87%	1.41%	2.52%	3.52%
DEX Federal Bond Index	-7.86%	-2.62%	7.28%	3.73%	2.39%	0.13%	3.66%
DEX Provincial Bond Index	-12.92%	-3.28%	9.86%	9.07%	0.66%	4.33%	4.14%
DEX All Corporate Index	-9.58%	-1.34%	8.74%	8.05%	1.10%	3.38%	2.71%
DEX “A” Corporate Index	-10.29%	-2.30%	8.98%	9.65%	0.51%	4.42%	2.62%
DEX Real Return Bonds	-14.35%	1.84%	13.02%	8.02%	-0.05%	0.72%	2.79%
DEX High Yield Bonds	-6.25%	6.18%	6.69%	8.48%	2.15%	5.20%	13.79%

Comments

Bond yields have risen at all maturities thus far in 2022 and are poised to move higher. The U.S. two-year note has jumped by 250 basis points, while the 10-year has moved 150 basis points higher so far this year. The net effect of this slump in bond prices has been deeply negative performance, one of the worst stretches ever.

The rise in bond yields in April was driven by the twin forces of inflation and a hawkish Federal Reserve. The U.S. 10-year reached 2.34% at the end of March but has surged to 3.10% at present. This bond reached a low yield of 1.73% in February when the conflict erupted in Ukraine, resulting in a flight to quality.

The yield curve has flattened significantly with the spread between two-year and 10-year yields inverting briefly before returning to the present positive spread of 30 basis points.

Inflation has been the key statistic this year. The Consumer Price Index (CPI) reading was 8.6% for May on a year-over-year basis, the highest since 1981. More importantly, it shows no signs of slowing down. The Federal Reserve does not think so either. After raising the Fed Funds rate by 25 basis points in March, it left little doubt that more hikes were coming, possibly

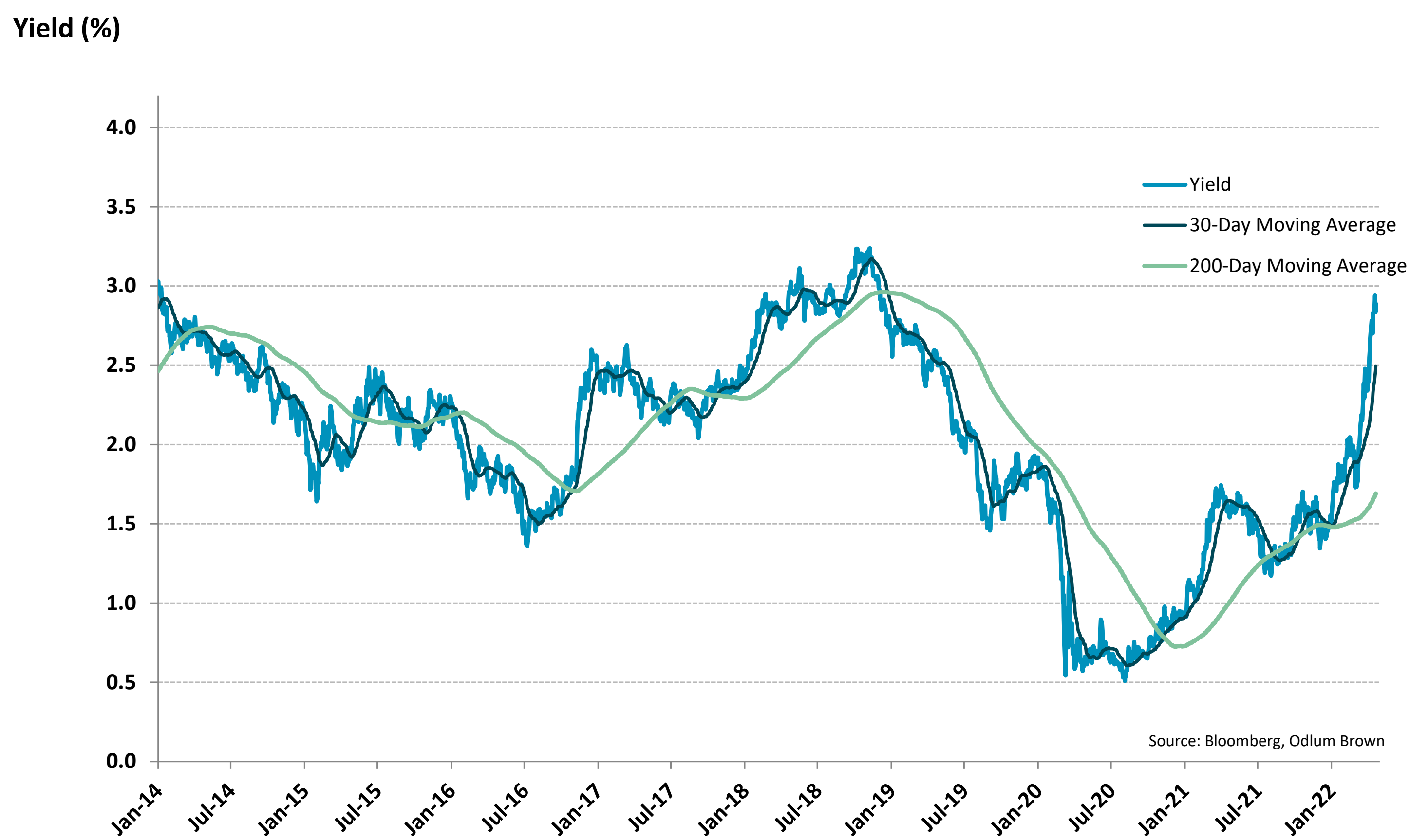
50 basis points at a time. Indeed, at the meeting on May 4, it raised the Fed Funds Rate to 1%. At the same time, the Fed laid out its quantitative tightening strategy to reduce its balance sheet by $95 billion per month.

Importantly, the labour market remained taut with the unemployment rate hitting 3.5% and wage pressures evident. There are 11.4 million job openings in America, more than the number of unemployed by approximately two million.

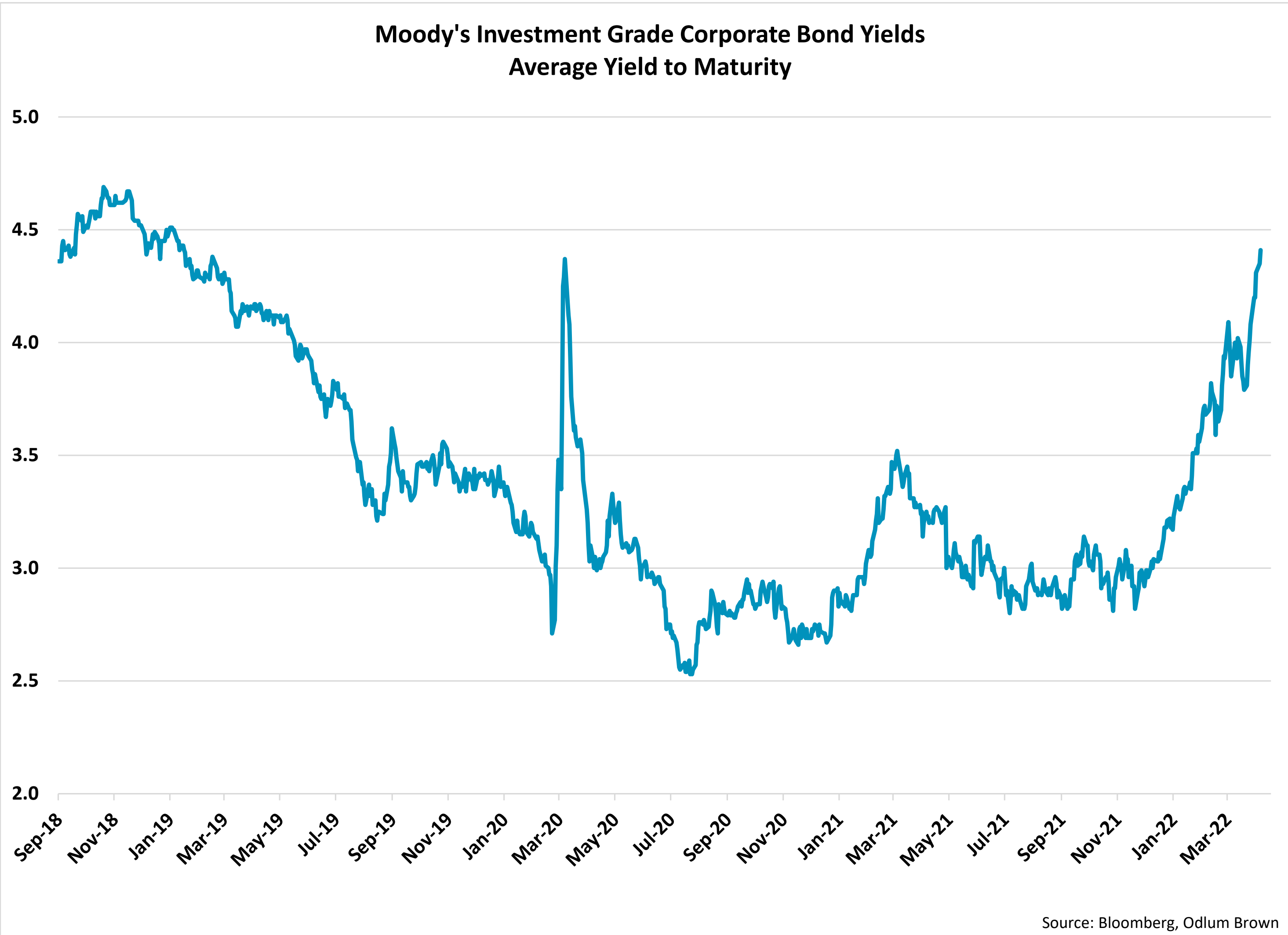
Canada has also enjoyed buoyant economic times with a record trade surplus and a blowout employment report. The Bank of Canada followed through on its rate hike forecast by raising its key rate by 25 basis points on March 2, a further 50 basis points on April 13 and 50 basis points more on June 1. It also confirmed that it would continue its quantitative tightening.

While corporate bond yield spreads, both for investment grade and high yield bonds, have widened, they are at or below their long-term averages. Issuance of new corporate bonds has eased significantly with yield concessions occurring in certain instances.

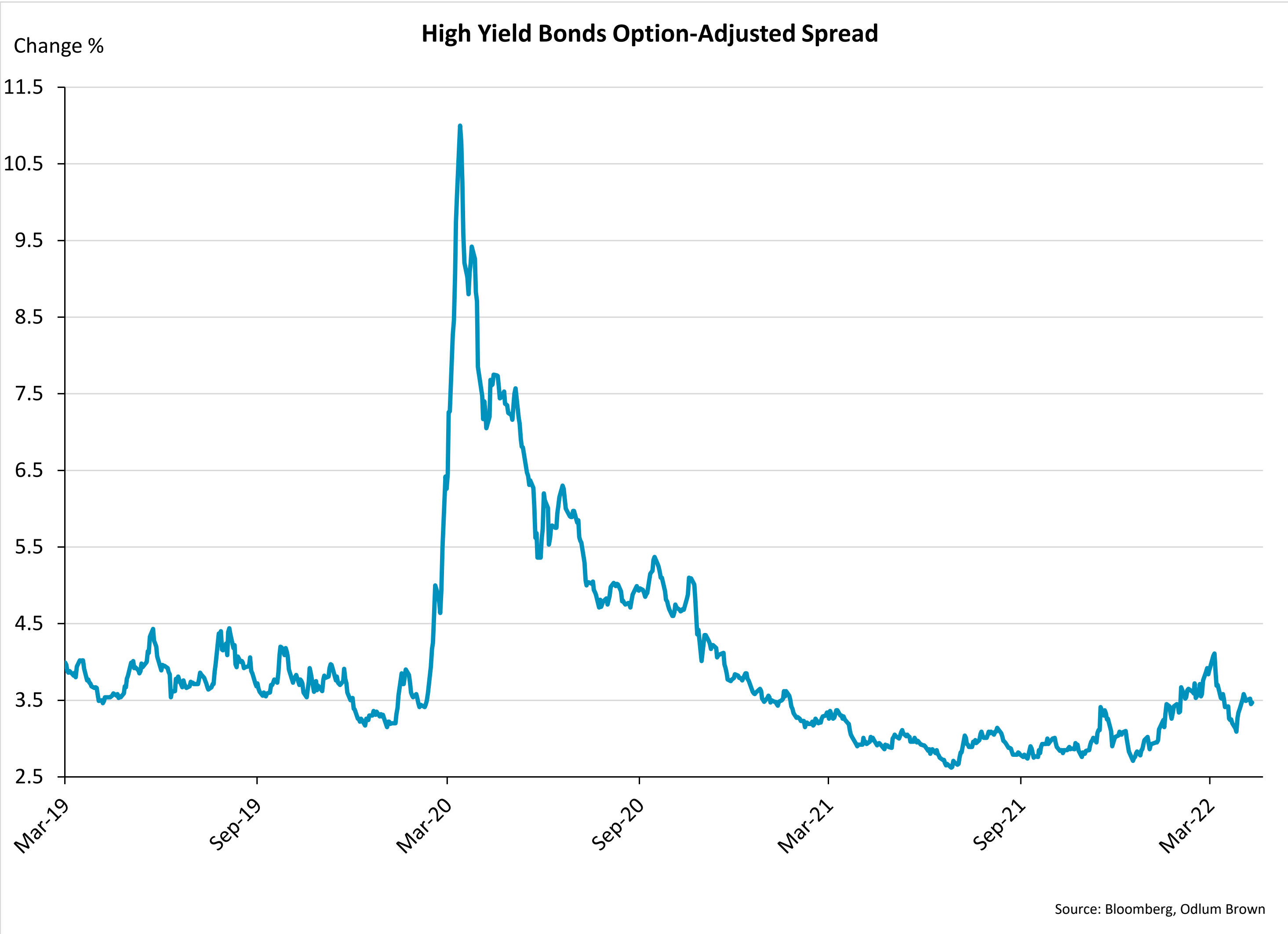
U.S. 10-Year Treasury



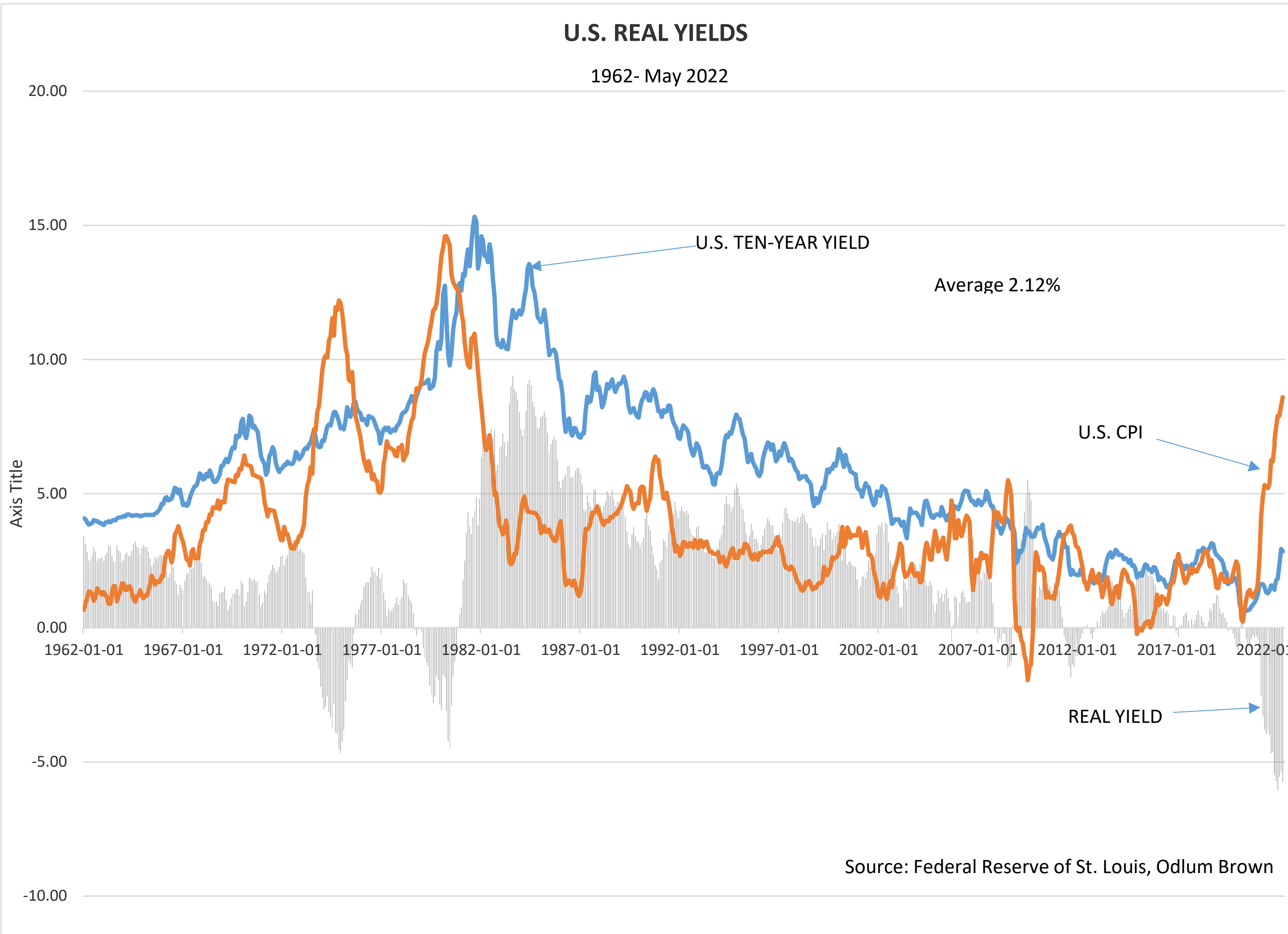
This bellwether's yield has soared despite being interrupted by a couple of significant flights to quality. Inflation, a tight employment situation and a hawkish Federal Reserve have all contributed to this rise in bond yields. The next major technical hurdle is 3.25%; however, periodic rallies are likely after such a swift selloff.



Investment grade corporate yields have soared with U.S. Government yields. Spreads have been well behaved.



Demand for high yield bonds has eased considerably. Spreads have widened 75 basis points so far this year but have been relatively stable of late.



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, this relationship will be restored between bond yields and inflation.

Outlook

The Federal Reserve and the Bank of Canada have begun to remove monetary accommodation and there is more tightening to come. To date, there has been little impact on economic data nor has the geopolitical conflict fed into the mix. Indeed, the Fed has maintained a positive economic outlook and is forecasting the inflation rate to average out at 4.3% for 2022. Many central banks, including the Bank of Canada, the Bank of England and the ECB, have joined the Fed in tightening.

The Fed and the Bank of Canada have discussed their plans to return to the so-called “neutral” level for their key lending rates. This rate is projected to be 2.5%-3% and, barring a major exogenous shock, is likely to occur.

It is reasonable to acknowledge that growth, both domestic and global, will suffer somewhat. Indeed, the IMF has downgraded global economic growth for this year and next to 3.6% versus previous estimates of 4.4% and 3.8%, respectively. Consumer sentiment has ebbed but retail sales have held up. A major concern is whether capital spending will be reduced or delayed. Meanwhile, the geopolitical landscape has produced wide-spread uncertainty, and even more inflationary pressure.

Real yields are rising rapidly and have moved into positive territory. A combination of further increases in bond yields, plus some easing in inflation will result in real yields turning even more positive. Thus, we expect yields at all maturities to gain further with a 3.25% target for the bellwether 10-year U.S. note. Corporate bond yields will move up in at least a similar fashion and possibly widen further from Treasury yields. Corporate financial health remains solid.

Wage pressures are escalating and may prevent the inflation rate from falling back to 2%. Commodity prices have soared of late too. Long-term deflationary pressures, such as demographics and technology, will re-emerge eventually and help ease inflation. Overall, inflation will be slow to subside. Most forecasts, including those from the central banks, estimate it will land between 4-5% this year.

It is likely that the Fed will be flexible in its monetary policy, owing to the uncertainty around growth and the geopolitical conflict. Already, the market has discounted several rate hikes and thus is not likely to react in a knee-jerk fashion. Also, the beginning of quantitative easing by the Fed and other central banks will impact market yields negatively.

Given this outlook, returns for fixed income investors will continue to be disappointing.

Strategy

Inflation is the enemy of bond investors and will remain a major negative for the foreseeable future. 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.

Specifically, we recommend a laddered approach using the **Odlum Brown Corporate Bond Ladder**. Also, we recommend individual floating-rate bonds. The Odlum Brown Model Bond 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.