CUMBERLAND
Private Wealth

FIXED INCOME - YEAR END REVIEW

2020: Going with the Flow

Where do I start? This was an unconventional year for sure... I think I'm sick of Covid-19 (yes, a bad pun)….

Anyhow, change and uncertainty often induces fear and anxiety. Covid-19 brought on government mandates/restrictions resulting in a change in everyone's "normal" course of life. But let's be positive, at least the year is over and vaccinations are starting around the world, hopefully there is some stabilization in spread soon.

Everyone had to pivot this year in some shape or form - professionally, mentally, emotionally or physically. Governments found ways to keep their economies afloat with stimulus programs, including support by their respective central banks, engaging in quantitative easing. What can be said about 2020 on a positive note, is that it accelerated "growth" – probably more in our mindset. People, companies and governments, who wanted to persevere, were forced to face challenges head on: like enhancing antiquated technology, making a better effort to connect with people, uniting as a team, and just being open enough to "go with the flow".

As we were forced to stay at home, let's recap the COVID-19 stats[1] in Canada (as at Dec 30th):

13.8MM the number of people tested, with 6.4MM in Q4 (an 87% increase since YTD Q3)

572,982 the number of people confirmed to be infected, with an increase of 414,224 infected cases in Q4 alone (a jump of 260% from YTD Q3)

15,742 The number of people who died, with 6,445 deaths in Q4 (a jump of 69% from YTD Q3 totals)

1.https://www.canada.ca/en/public-health/services/diseases/2019-novel-coronavirus-infection.html

Markets, as usual, were volatile. While we endured some unthinkable lows, we also witnessed some incredible recoveries by the end of the year. The challenges of COVID-19 are not quite in the rearview mirror and are still evolving. However, with 9 months under our belt and a few vaccines ready for mass distribution, people are getting onside with executing a plan to stabilize the infection rate. Optimism is in the air that there will be a light at the end of the tunnel.

Some notable highlights during the year below (red=bad, green=good).

Exhibit 1: Market Indicators

	Trough	Current Status
WTI Crude Oil (USD)	-$37.63/bbl on April 20	$48.23/bbl (228% recovery from lows)
S&P 500	2237 on March 23, 2020	3730 (67% recovery from March low)
Price of Gold (USD)	1471 on March 19, 2020	1896 (peaked at 2063 August 6, 2020)
Currency (CAD/USD)	0.6891 on March 19, 2020	0.7840 (14% recovery from March low)

Source: Bloomberg

Exhibit 2: Canada and US Current Status

	United States		Canada	
	Highlight	Current Status	Highlight	Current Status
Overnight Interest Rate	Cut by 150bps[2] to 0% (Mar)	Federal Reserve guided to being status quo until 2023	Cut by 150bps[2] to 0.25% (Mar)	Bank of Canada guided to being status quo until 2023
Unemployment Rate	Peaked at 14.7% (Apr)	Now at 6.7% for most recent read	Peaked at 13.7% (May)	Now at 8.5% for most recent read
Inflation (CPI)	Peaked at 2.5% (Jan)	Now at 1.2%	Peaked at 2.4% (Feb)	Now at 0.7%
Balance Sheet Assets (Central Bank)	$4.2 trillion pre-pandemic	$7.4 trillion	$120 billion pre-pandemic	$548 billion
2020 Fiscal Government Deficit		~$3 trillion		~$380 billion
Total Debt/GDP	107%[3] (Q1 2020)	~127%[3] (Q3 2020)	31%[4] (2019-2020)	~49%[4] (2020-2021)

Source: Compiled by Cumberland Investment Counsel from Bloomberg, Bank of Canada

2. 1bps is equal to 0.01%
3. https://fred.stlouisfed.org/series/GFDEGDQ188S
4. https://www.canada.ca/en/department-finance/services/publications/economic-fiscal-snapshot/debt-management-strategy-2020-21.html

Debt Surge to Save the Economy

With a stimulus program in place, the Canadian federal government rushed to issue more debt to fund various programs. In conjunction, the Bank of Canada announced its first ever quantitative easing program this year. This facilitated refinancing and borrowing for all levels of government and corporate issuers. The Bank of Canada bought back (and is continuing to buy) bonds in both the primary and secondary markets, increasing its assets on its balance sheet which currently sits at a record peak of $548bln (vs. $120bln at the beginning of the year). Exhibit 3 below highlights the debt issuance completed and expected to be issued at the federal and provincial levels. Note that growth on a combined basis of the federal and provincial governments debt, has increased by 164% versus last year, with the federal government incurring almost 230% more than the prior fiscal year.

Exhibit 3: Government Debt Standing

In $ Billions	**Fiscal 2019/2020[5]**	**Fiscal 2020/2021[5]**			**Growth Year Over Year(%)**
	Completed	Completed to date	Remaining	Total Expected	
Government of Canada	114.0	321.0	53.0	374	228%
Provincial Borrowings					
British Columbia	5.7	10.4	3.6	14.0	148%
Alberta	7.6	20.4	9.5	29.9	295%
Saskatchewan	1.9	4.1	0.3	4.5	135%
Manitoba	4.3	7.4	0.4	7.8	84%
Ontario	39.5	42.1	10.2	52.3	32%
Quebec	20.0	32.5	0.0	32.5	62%
New Brunswick	1.9	1.6	0.2	1.7	-10%
Nova Scotia	1.5	1.7	0.8	2.4	62%
P.E.I	0.1	0.1	0.1	0.2	100%
Nfld & Labrador	1.2	2.8	0.2	3.0	150%
Total Government Debt Issuance	198	444	78	522	164%

5. Fiscal Year April 1- March 31
Source: National Bank Financial, Bank of Canada

On the Canadian investment grade corporate bond issuance front, we witnessed a high volume of new issuance in 2020, setting a new 10-year annual record with $116bln of new issuance in the year (vs. $111.8bln in 2019). With interest rates so low, most of the issuance was skewed to the mid part of the curve (5-10 years) as issuers took advantage of cheap funding and the ability to extend the term of their debt.

Of the new issuances, 42% was rated BBB (the lowest category in investment grade ratings) and 39% was rated A. As a proxy, in 2019, the corporate bond index was made up of just shy of 41% of BBB issuance, at the end of 2020, it was 45% of the index. We saw inaugural BBB issuers and existing BBB issuers take advantage of the low interest rates, and there were downgrades through the year from A rated issuers that bolstered the percentage of BBB in the index.

While the Bank of Canada launched a program to buy corporate bonds in the secondary market in May, they have only purchased $182MM out of $6.3Bln (despite several reiterations of the process targeted to increase participation). The lack of uptick to the Bank of Canada program shows investors' desire for more yield (with 10-year Government of Canada bonds only yielding 0.68%). New corporate bond issues were oversubscribed by more than 10x the face amount being issued. All-in yields are low: the corporate bond index with a 7-year duration yields only 1.74%, but still at a premium to Government bonds yields.

Lower Rates for Longer?

With the overnight interest rate at 0.25%, many are wondering when the Bank of Canada will increase the rate again soon. While the Bank has guided to keeping the overnight interest rate unchanged into 2023, some economists/investors are anticipating the Bank's projections are too conservative and that an increase in the overnight rate will happen sooner than 2023.

Let's examine what drives the Bank of Canada's decision to raising the rate sooner than 2023.

There are 2 main drivers: 1) unemployment and 2) inflation.

With the unemployment rate still at an elevated level (8.5%), there has to be a continued strong recovery post-COVID-19 for the Bank to (re)consider. We note that at the best of times prior to pandemic, the unemployment rate ran as low as 5.4%. Also, back in July 2017, when the Bank of Canada started increasing the overnight interst rate the last time (after a 7 year long stretch without any increases), the reported unemployment rate was closer to 6.5%. Until the dust settles and there is more clarity on what the "new normal" will look like, it remains difficult to predict when Canadian productivity levels (and thus employment) will ultimately recover and if it will stabilize quicker than the Bank's current projection.

Next is inflation. Every 5 years, the Government of Canada and the Bank of Canada renews Canada's Inflation-Control Target Agreement which targets 2% in inflation (with a control range between 1% to 3%). This agreement ends December 31, 2021. We expect the renewal to go as planned and be consistent with prior arrangements. In the Bank of Canada's last meeting of 2020, they were looking to see inflation stabilize around 2%. This 2% target level, within a range, will be required for a sustained timeframe prior to any increase in the overnight interest rate. Some feel that we will see a spurt in inflation in the near term, which will lead to the need for interest rate increases. While I agree with the former concept, I think stability of inflation within the acceptable range of around 2% for the Bank of Canada to hike will be the issue. It is likely that businesses will continue to pass through "pandemic" related costs to end consumers which would result in a near-term spike in inflation, but stability of this 2% target over time could be a more difficult task to achieve.

We believe the overnight rate will remain steady in the near-term and even a potential further cut to 0% is likely if the spread of COVID-19 infections continue to increase and longer lockdown periods are in place. We do not, however, believe the Bank of Canada will settle on cutting the overnight interest rate lower than 0%.

The yield curve, though, could remain inhibited from aggressive near-term steepening because of:

1) the Bank of Canada's yield curve control (along with their intention to purchase longer dated government bonds in their quantitative easing program); and
2) international demand - with about US$17.8 trillion of negative yielding bonds around the world (an increase of almost 7 trillion since the start 2020), there is demand for any positive yield.

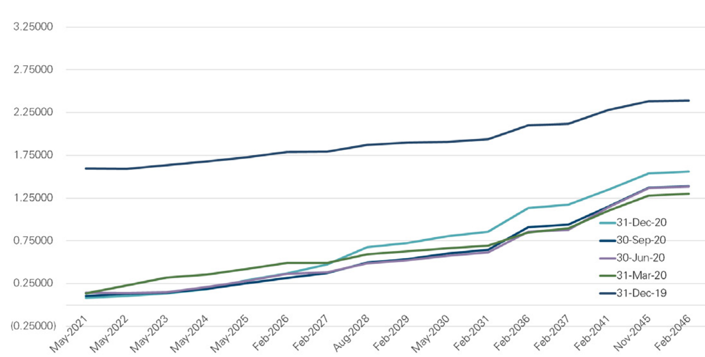
As a result of the above, this could keep Canadian bond prices from falling and yields lower.

Quarter & Year Review

During the quarter the Federal Reserve ("the Fed') kept interest rates unchanged at 0% (lower bound) in Q4. The expectation is that the Fed will keep interest rates at the lower bound until there is an improvement in unemployment levels and likely through 2023 at this point. With inflation being another key driver to how the Fed will decide on overnight interest rate increases, they have set out that the target inflation will need to average 2% over time, giving them flexibility of inflation volatility in the near term.

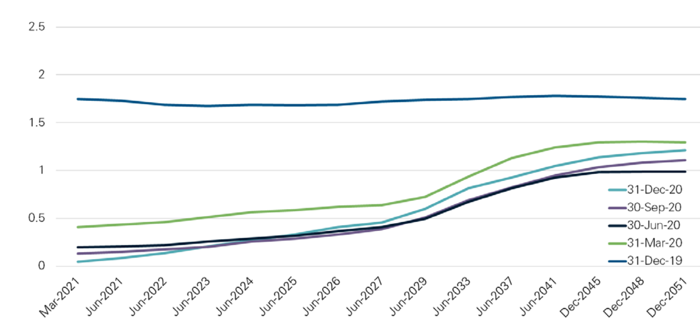
Interest rates for the quarter were mixed with 1-year to 3-year interest rates moving 1bp to 2bps lower and the rest of the curve moving 4bp to 23bps higher as the curve in general steepened out. For the year, interest rates moved lower anywhere between 83bps to 151bps lower across the curve.

Exhibit 4: US Yield Curve



Source: Bloomberg

Exhibit 5: Canada Yield Curve



Source: Bloomberg

The Bank of Canada kept their overnight rate unchanged in Q4 at 25bps. Similar to the Fed, the Bank of Canada will keep overnight interest rate unchanged for the medium term and projected no movement in overnight interest rates until 2023. The Bank of Canada did not adjust any language regarding their inflation target of 2%.

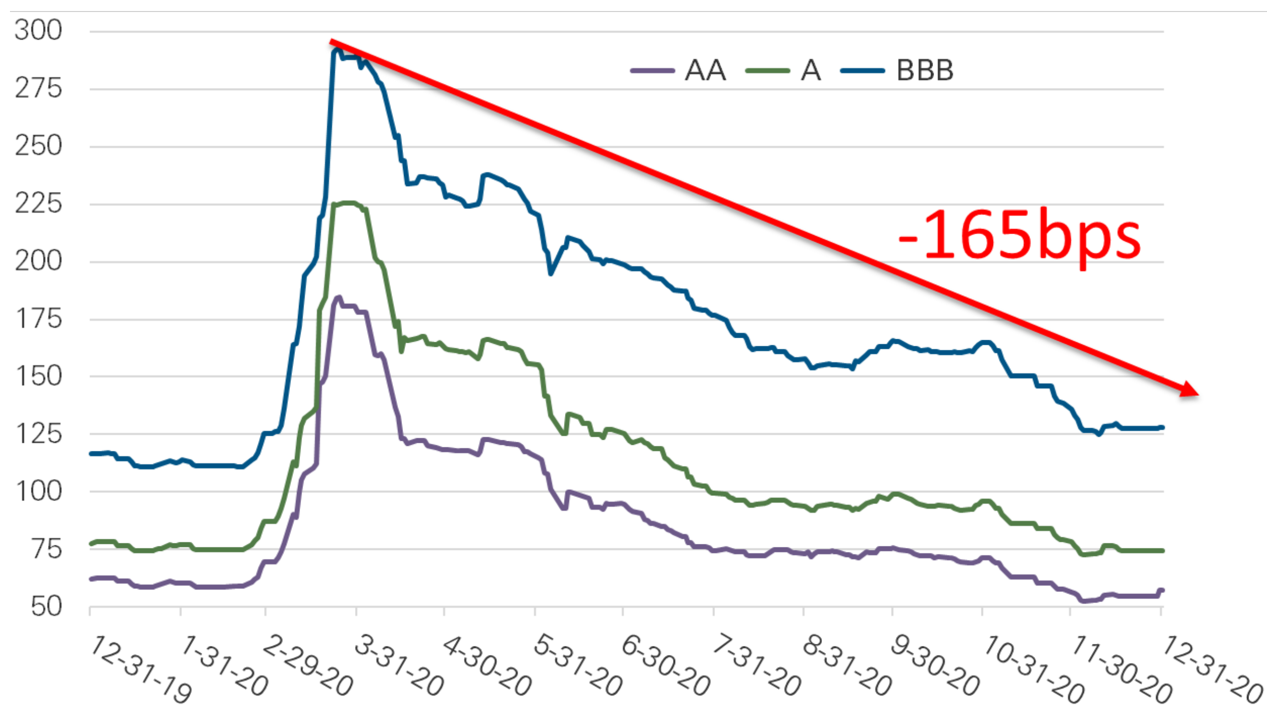
Interest rates for the quarter were mixed as 1-year and 2-year interest rates were lower by 4bps to 9bps, while the rest of the curve was higher anywhere between 1bp to 13bps. The volatility of the 10-year Government of Canada bond was lower than previous quarters, but still relatively high as it moved from peak to trough 43% during the quarter (vs. 65% in Q3, 59% in Q2 and 68% in Q1).

For the year, interest rates moved lower anywhere between 54bps to 170bps across the curve while the 10-year Government of Canada bond moved 293% from peak to trough vs. 86% in 2019.

Canadian investment grade corporate spreads were tighter anywhere between 18bps to 38bps across the curve and rating categories during the quarter. The best performing segment for the quarter were BBB credits. On the year, spreads were mixed with spreads wider as much as 12bps and tighter as much as 4bps. BBB credits, for the most part, underperformed on the year; while A rated credits fared the best across the curve.

Spreads widened out very quickly during the beginning of the pandemic in March (see Exhibit 6 below), but have tightened in as much 165bps since peaking and are almost back to the start of 2020 levels (in some instances even tighter). Note that 165bps is equivalent to about a 7% price move in 5-year bonds.

Exhibit 6: 5-Year Investment Grade Corporate Spreads



Source: BMO Capital Markets

Returns for various fixed income asset classes are shown in the table below.

Exhibit 7: Returns for Fixed Income Asset Classes

Asset class returns	Q4/20	Q4/19	2020	2019
Bond Universe Index	0.63%	-0.85%	8.68%	6.87%
Corporate Bond Index	1.80%	0.06%	8.74%	8.05%
FTSE High Yield Canadian Index	4.12%	1.37%	6.69%	8.48%
S&P/TSX Preferred Index	3.52%	4.09%	6.11%	1.99%

Outlook & Strategy

New year, new beginning? Well… at least for our friends down south, a new President will take over this month. Global relations might be less contentious than in the last four years. With that, many of the issues that were big drivers of volatility in the bond market and were put aside because of COVID-19, might reemerge but with less impact (namely US/China trade war).

We do anticipate that infection spread of COVID-19 will at some point stabilize from a combination of: change in individual behaviour (as more individuals make it common practice to wear a mask, are more cautious about hand washing, or just generally giving people distance); vaccination; or from outright mandated lockdowns.

The yield curve ended steeper than when we started 2020, but we believe once COVID-19 is stabilized, we could see more steepening (before it is buoyed by yield curve control or investor demands). The 30-year Government of Canada bond ended 2020 with a yield of 1.22%, but was still lower than at the end of 2019 (though the landscape is quite different this time around). We do believe that there still needs to be more value for us to lock-in yields in long-dated bonds.

At the end of 2020, 99.5% of the bonds in the Canadian Bond Universe traded above par. At the end of 2019, 89% of bonds in the index traded above par. All-in bond yields are now even lower than where they started in 2020 with the Canadian Bond Universe Index at 1.21% vs. 2.29% at the end of 2019.

Having said that, there are opportunities though, and we continue to trek on with our strategies as planned and focus on the credit work with our investments. We continue to be cautious in stretching for that incremental small amount of yield and adding a disproportionate amount of risk. Our goal is to continue to preserve capital and manage our clients' risk.

All the best for 2021!

Take Care,
Diane Pang

Diane

Lead Manager,
Cumberland Fixed Income*
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*Cumberland Private Wealth refers to Cumberland Private Wealth Management Inc. (CPWM) and Cumberland Investment Counsel Inc. (CIC). Diane Pang (a Portfolio Manager at CIC) is the lead portfolio manager for the Cumberland Income Fund and the Kipling Strategic Income Fund. NCM Asset Management Ltd. (NCM) is the Investment Fund Manager to the Kipling Strategic Income Fund. CPWM, CIC and NCM are under the common ownership of Cumberland Partners Ltd.