CUMBERLAND

Private Wealth

FIXED INCOME - FIRST QUARTER 2023

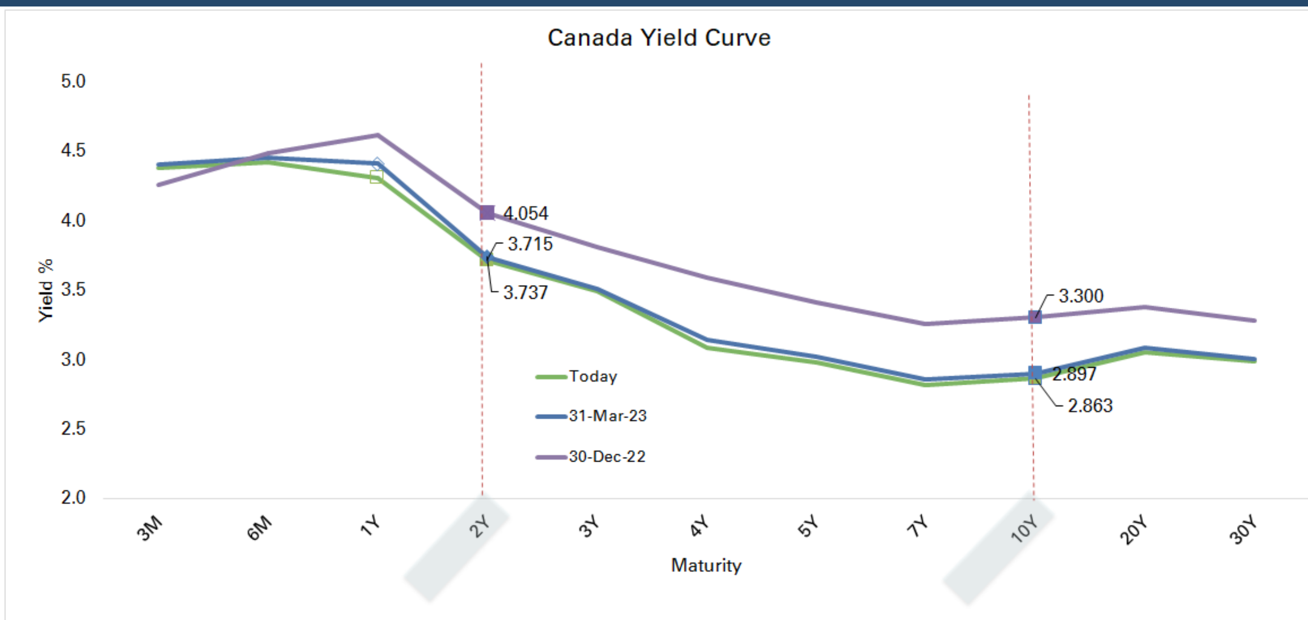
The drivers of positive fixed income returns for Q1 2023, in no particular order, were the effective management of the isolated bank liquidity crisis, the central banks' (Canada and the US) higher interest rate policies and the increase in corporate interest rate spreads (incremental return over government bond yields). After this positive start for fixed income investors, based on the fundamentals we continue to see, we retain our positive bias for income investments for the remainder of the year.

Fixed Income Markets Quarter in Review

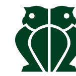
As shown in the chart below, the Canadian yield curve shifted lower in most tenors, and remained inverted during Q1 2023. The primary driver of the lower rates was the banking crisis, headlined by Silicon Valley Bank. The prospect of systemic risk to the US and global financial banking ecosystem caused by the failure of a top-20 US bank (and subsequently others, such as Credit Suisse and Signature Bank) in mid-March cast a shadow over the market, with market conditions tightening almost overnight. The swift and significant actions by the US government and central bank to address the situation brought stability back quickly, but uncertainty remains. In addition, the Bank of Canada hiked the overnight lending rate by 25 bps in late January, but paused in its latest decision in early March, buoying markets to anticipate the end of the rate hike cycle for Canada.

Interest rates decreased in the 2-10 year terms by an average of 38 bps. The 2-year bond yield moved 13.2% from peak to trough. The movement in the bellwether Canada 10-year bond yield was 16.3% from peak to trough, vs. a 12% movement in Q4/22 for the same issue.

Canadian Yield Curve



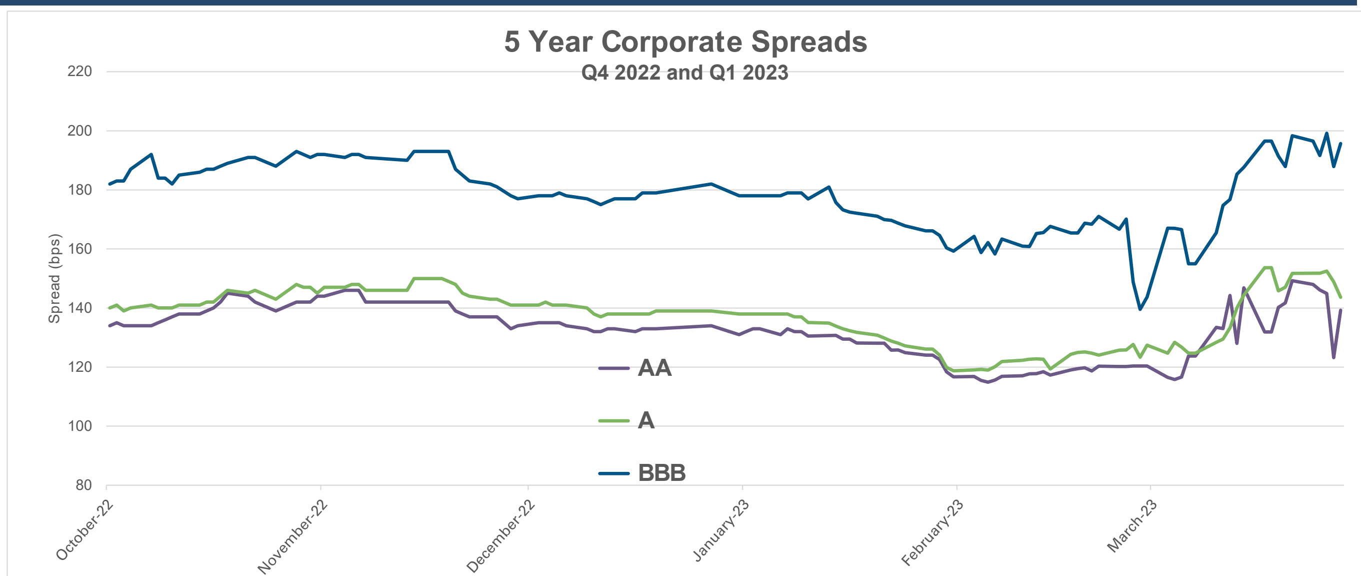
Source: Bloomberg



As you know, when interest rates decrease, bond prices increase, so this was a positive outcome for total returns for fixed income investors during the quarter.

However, as a result of the interest rate volatility, continued uncertainty and the general 'risk-off' tone of the financial markets, corporate bond spreads widened modestly during the quarter. BBB bonds widened by 14 bps in Q1, while the higher rated AA and A bonds widened by only 5 bps. When interest spreads widen, the interest rate increases, and their price decreases. The corporate bond spreads now sit at levels that are just below the highs reached in 2022. However, they are still well below those levels reached in the crisis of March 2020 when the Covid-19 pandemic impacted the financial markets. Finally, corporate bond spreads are generally viewed as a barometer for recession risk – while they suggest the risk of recession has increased slightly, they do not, at present, indicate that a recession is imminent.

5-Year Corporate Bond Spreads



Source: BMO Capital Markets

Despite the widening of corporate bond spreads, the sharp drop in the yield curve overall drove bond markets higher resulting in positive returns overall during the quarter. This was a timely outcome following a challenging 2022 for total bond returns. Longer duration bonds and strategies with longer duration, generated superior returns, as their sensitivity to the decreases in interest rate movements discussed above is higher. The more economic-sensitive sectors (i.e. corporate bond issuers) underperformed the broader fixed income index, they too still provided positive appreciation and returns for the quarter as shown below.

Returns for Fixed Income Asset Classes

Asset Class Returns	Q1 2023	Q4 2022	2022
FTSE Canada Universe Bond Index	3.2%	0.1%	-11.7%
FTSE Canada Corporate Bond Index	2.8%	1.0%	0.0%
FTSE Canada HY Bond Index	1.9%	2.1%	-5.4%

Source: Bloomberg

Bank of Canada Update

As predicted, the Bank of Canada (the "Bank") increased interest rates by 25 bps in late January. This left the overnight lending rate at 4.50% in Canada, its highest level since late 2008, and represented the eighth consecutive increase in rates. The increase of 425 bps over the course of the previous 9-10 months was the second fastest increase in recent history. However, the Bank's statement accompanying the last increase projected that CPI inflation for Canada would measure 'around 3%' in the middle of 2023 and back to the 2% target by 2024. The Bank also said that it expected to hold the policy rate at its current level as it assesses the impact of all the rate hikes on the economic environment. The Bank had announced it was on pause (absent material deviation from its economic forecasts). At the Bank's most recent meeting on March 8th, it did just that, holding the overnight interest rate at 4.5%.

The Canadian economy is currently wrestling with two primary counterforces – economic growth (positive but perhaps slowing), and inflation (too high but also seemingly retreating). Economic growth stalled in Q4 2022, with zero GDP growth reported, below the market expectations. However, this weak figure was largely due to a slowdown in inventory investment. On an annual basis however, GDP measured a respectable 3.0% as of the end of January 2023, with consumer consumption, government spending and net exports all increasing, a positive sign in our view. However, the higher interest rate environment is expected to weigh on future household spending and on business investment. Inflation continues to remain at excessive levels but has declined for eight consecutive months. Annualized CPI inflation measured 5.2% at the end of February, and measured 3.2% for the most recent 3 months on an annualized basis. This is material progress towards the Bank's stated inflation target. The labour market continues to be tight, but with moderating growth being forecast, this may change in the coming months and quarters.

The broader financial markets currently appear to agree with the Bank and largely accepts its outlook. Perhaps in recognition that it was tardy in commencing the rate hike cycle in late Q1 2022, the Bank's decision to aggressively hike in the summer of '22 (recall the unexpectedly high 100 bps hike in July, followed by a 75 bps hike in the subsequent meeting) appears to be working. The market currently anticipates no further rate hikes this year, and is forecasting a potential 25-50 bps rate cut by the end of 2023. Our view remains that we anticipate no changes (hikes or cuts) for the remainder of the year. Future movement in the interest rate, beyond 2023 will be driven by the Bank's assessment of the health of the economy and the rate of inflation relative to its target range of 2-3%.

U.S. Update

In Q1 2023, the trends for the US economy, evident in late 2022, remained in place – high but declining inflation, a very tight labour market, and surprisingly resilient economic growth. The shock of the banking liquidity crisis caused rates to fall, and the market believes the Federal Reserve Bank (the "Fed") is tantalizingly close to the completion of its interest rate hike cycle. U.S. annualized Consumer Price Inflation ("CPI") declined to 6.0% as of the end of February, representing eight consecutive monthly decreases since the peak inflation run rate measured in June 2022. The interest rate hikes are clearly having the desired effect.

A positive driver in support of future US economic growth is the continued tightness of its labour market. The unemployment rate measured 3.5% as of the end of Q1 2023, near all-time lows. It has exceeded expectations for several months, and we view its strength as a strong buffer against recessionary forces from other areas of the economy.

US Gross Domestic Product ("GDP") growth year over year declined to 0.9% with the Q4 2022 measurement, the most recent reading available as of this update. This was despite two consecutive negative quarterly GDP growth measurements in Q1 and Q2 (technically a recession occurs with two consecutive negative quarterly GDP growth results), however, interestingly Q4 (quarterly) GDP expanded by a higher than expected 2.6%.

The Fed hiked rates by a total of 50 bps in the last quarter, consisting of two increases of 25 bps apiece, and in line with investor and market expectations. The Fed Funds Rate currently sits at 4.75%.

The market currently anticipates a 75% chance of another 25 bps interest rate hike at its upcoming May 3rd meeting, and for the Fed Funds Rate to peak at 5% in 2023. However, it also currently anticipates that rate cuts will ensue, with 25 bps priced in by September, and for the rate to finish 2023 at 4.25%. We anticipate, like the Canadian situation, for the Fed to pause and watch the state of the economy and pace of inflation in the second half of 2023.

Outlook and Strategy

Our conviction that we are near or at the end of the rate hike cycle is higher than when we wrote about it in our 2022 year-end review.

We do not currently anticipate any further rate hikes here in Canada.

In the US, we may have one more interest rate hike to navigate in early May, however, we think we are very close to the end of the Fed's hiking cycle as well. Inflation has consistently trended downwards for several months now, and the banking liquidity crisis seems to be under control at this time.

We have not wavered in our belief that should a recession occur, it will be relatively mild. However, we believe the risk of recession has increased slightly in the past three months as a result of tightened financial conditions, and the ongoing effect of the past year's interest rate hikes on consumer demand. This is buttressed by the slightly wider corporate bond spreads we discussed earlier.

As a result, we have begun adding term and duration to the portfolio (by buying longer dated maturity bonds), and will likely continue to do so in a patient manner. The lack of urgency in lengthening duration materially now, is because at present, as shown in the chart earlier, the yield curve is inverted. The shorter end of the curve is where the highest bond yields reside at the present time - in other words, investors are still not getting paid more to hold long bonds vis-à-vis short term ones as they would in a normal, upward sloping yield curve environment. But we believe that over the next 6-12 months, this will normalize towards a flat or upward sloping curve.

Yields remain compelling, and we see opportunities in existing bond investments, most of which are still trading below par, and therefore offer relatively higher tax-advantaged returns. But we are also seeing attractive new issues (for example, new issue bonds from the major Canadian banks offered close to a 5% coupon very recently).

We are focusing our research emphasis towards higher quality credits (e.g. federal, provincial and agency bonds), and on the corporate bond side, towards investment grade issuers.

All in all, we remain constructive on fixed income as an attractive place to allocate investment funds at this time.

Thank you.

Kind regards,
Owen Morgan
Portfolio Manager
Cumberland Income Fund
April 11, 2023

*Cumberland Private Wealth refers to Cumberland Private Wealth Management Inc. (CPWM) and Cumberland Investment Counsel Inc. (CIC). Owen Morgan (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.

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