FIXED INCOME - SECOND QUARTER 2023

Fixed Income Markets Quarter in Review

In a reverse from Q1, the Canadian yield curve level (the general, reflecting overall value of interest rates across the curve) shifted higher in Q2, with the more pronounced moves occurring in the short to medium term tenors (encompassing the 3 month to 7 year bonds). This is shown in the Canada Yield Curve chart below. Rates moved higher by an average of almost 60 bps across the curve. As bond investors, you know that when interest rates (yields) rise, bond prices fall, albeit modestly in this case.

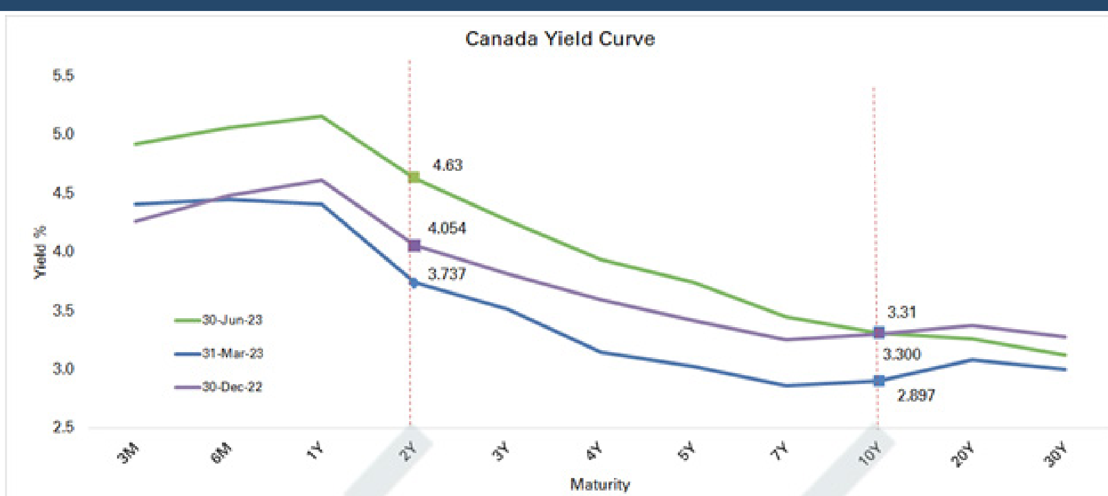
Returns for Fixed Income Asset Classes

Asset Class Returns	Q2 2023	Q1 2023
FTSE Canada Universe Bond Index	-0.7%	3.2%
FTSE Canada Corporate Bond Index	0.2%	2.8%
FTSE Canada HY Bond Index	0.7%	1.9%

Source: Bloomberg

The slope of the curve steepened negatively. The spreads between the 2-year and 30-year bonds' yields widened further from -74 bps to -149 bps. In other words, 2-year bonds currently offer almost 1.5% more in yield now than 30 year bonds do, while they offered 'only' 0.74% more at the end of March. The 2-year and 5-year spread moved from -72 bps to -89 bps, or 0.17% wider. Typically, longer-dated bonds offer investors more yield given the additional risks inherent in lending money over a longer timeframe. The yield curve is normally (but not always) a gently upward-sloping line from left (shorter dated bonds) to right (longer dated bonds). At present, and as has been the case now for the past year or so, the curve is 'inverted', with higher rates at the short end of the curve.

Canadian Yield Curve



Source: Bloomberg

What drove these changes; and secondly, what are the implications to investors?

The primary driver of the performance of various fixed income markets in the second quarter was inflation, and its effect on expectations of central banks policies. While inflation continued to decline on a year over year basis, measuring 3.4% as of the end of May (recall the peak figure this period was 8.1% in June of 2022), there were underlying trends and figures which clouded market sentiment and dulled risk appetite. For example, the April CPI reading of 4.4% marked the first month in the previous ten that the figure had risen. While the May figure of 3.4% represented a large drop, the market took note of that month's Core CPI figure, higher at 3.9%, with both statistics still seemingly a long way from the Bank of Canada's targeted 2%.

At a high level, growth as measured by GDP, slightly exceeded expectations during the quarter. This signals that the economic engine is more resilient than previously thought, and growth may continue longer. On the surface this may seem like positive news, however it is negative news from an inflationary perspective, as a stronger economy increases pricing pressures.

Unemployment also exceeded expectations during the quarter for the most part, and notably the Wage Growth figures were stubbornly high. As with the growth figures above, the labour market releases were positive for the economy, but negative for the fight against inflation.

The Bank of Canada took notice of these trends and statistics, and hiked its overnight rate by 25 bps to 4.75% on June 7, a slight negative surprise to the market (and most strategists, with only 1 out of 5 predicting a hike). In its release, the Bank noted that underlying inflation remains stubbornly high, and that excess demand in the Canadian economy looks to be more persistent than anticipated.

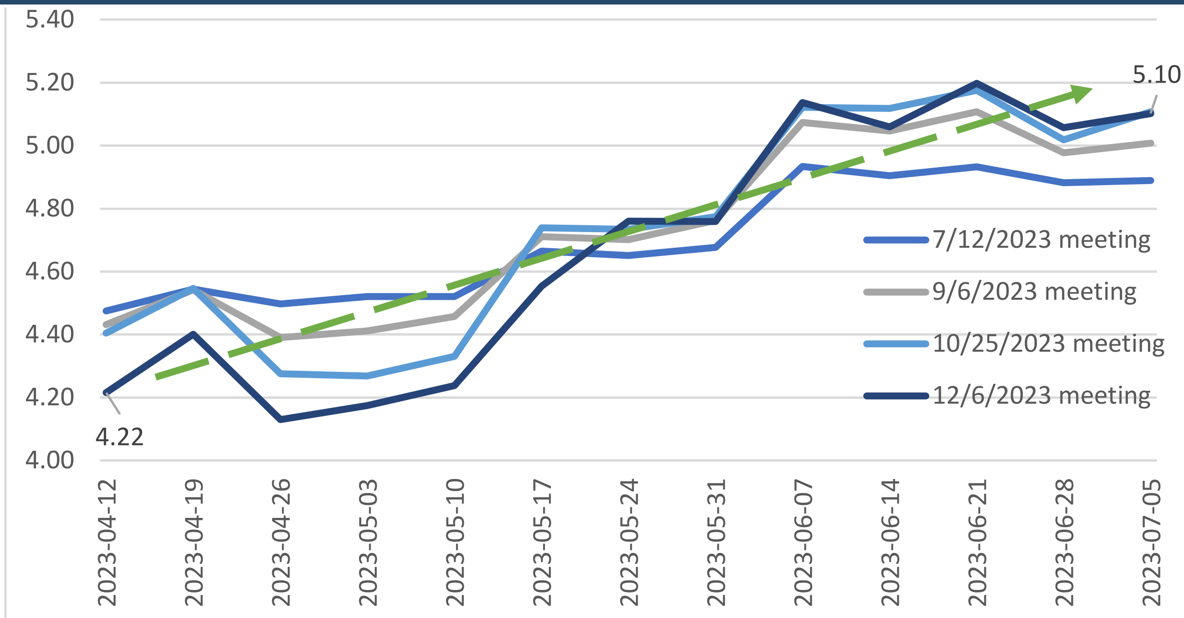
These factors caused the bond market to re-assess the probabilities that interest rates would be 'higher for longer', and yield levels rose (and prices fell), more so in the short end, as shown in the Canada Yield Curve chart above.

Where are interest rates headed?

With the Bank of Canada hiking at its most recent meeting, and indicating that additional hikes may be necessary, the market has taken notice as we described above. As shown in the chart below, the implied Policy Rate has risen over the course of the last several weeks. For example, on April 12th, the market expected that the Policy Rate at the Bank of Canada rate decision on December 6, 2023 would measure 4.22%. Since then, the expectation has risen, and as of today's writing, the implied Policy Rate (again, at the December 6th decision date) is now 5.10%.

In addition, you no doubt noticed that the line for the December 6, 2023 implied rate has moved above the other meeting dates' implied rates over that same time frame. This tells us that the market is no longer expecting rate cuts before year end.

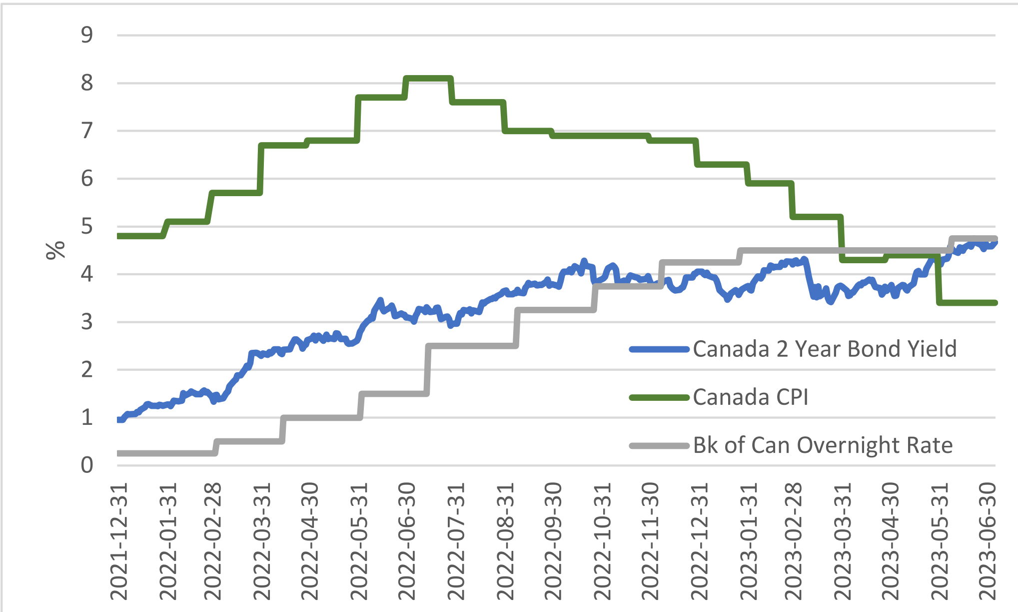
Implied Overnight Rate by Meeting Date



Source: Bloomberg

The market believes there is one 25 bps hike remaining, with a small chance of two hikes (totaling 50 bps). Our view is that we are very close to the end of the rate hike cycle, with likely one more increase in mid-July here in Canada. Looking at the following chart, which compares the bellwether 2-year government of Canada bond yield to inflation (as measured by CPI) and the Bank of Canada overnight rate, it is only recently that inflation has dropped below both interest rates. Our expectation is that inflation will continue to decrease, albeit in a slower and less linear manner (it will fluctuate / remain higher than perhaps we investors would like in certain months). This will lead to a stabilization in interest rates, although potential rate cuts are further down the road. 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%.

Inflation and Interest Rates



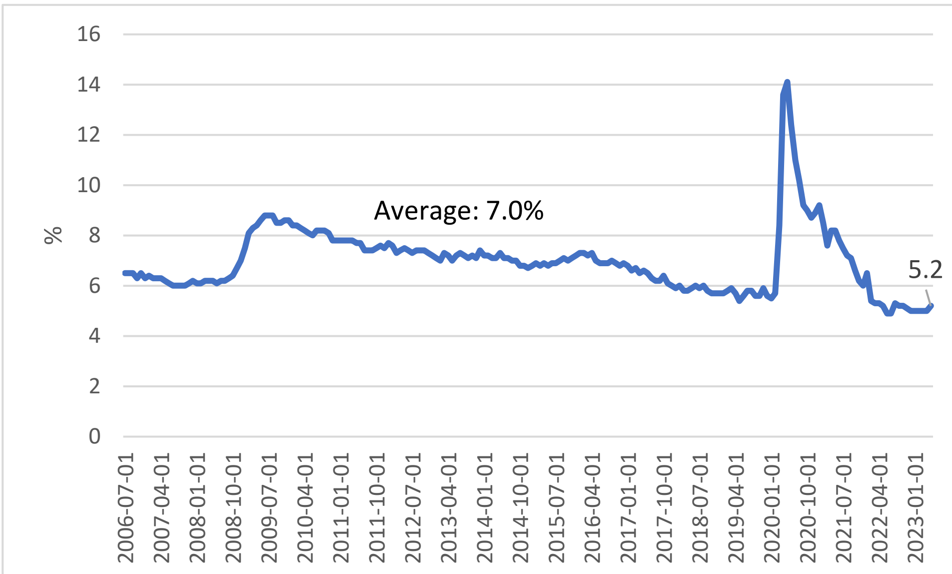
Source: Bloomberg

Given our expectations that the level of interest rates may rise (by 25 basis points), then it follows that appropriate positioning is to decrease interest rate risk by keeping duration (a measurement of interest rate sensitivity) low, or below benchmark. If we believe the Bank of Canada will pause after hiking rates in mid-July, we will add duration at that point.

In addition, given the shape of the yield curve, and that it is inverted, the most attractive rates are in the shorter tenors. As we mentioned, yields are more compelling than a few weeks ago. We also see opportunities in existing issues that are trading below par, and therefore offer higher tax-advantaged returns. But we are also seeing attractive new issues (for example, short-dated new issue bonds from some of the major Canadian banks offered a 5.5% coupon very recently).

We believe the odds of a recession have risen since our last update, however, should it occur we think it will likely be mild. There are two primary reasons that give us comfort in this respect, the unemployment rate and secondly, corporate bond spreads.

Unemployment Rate

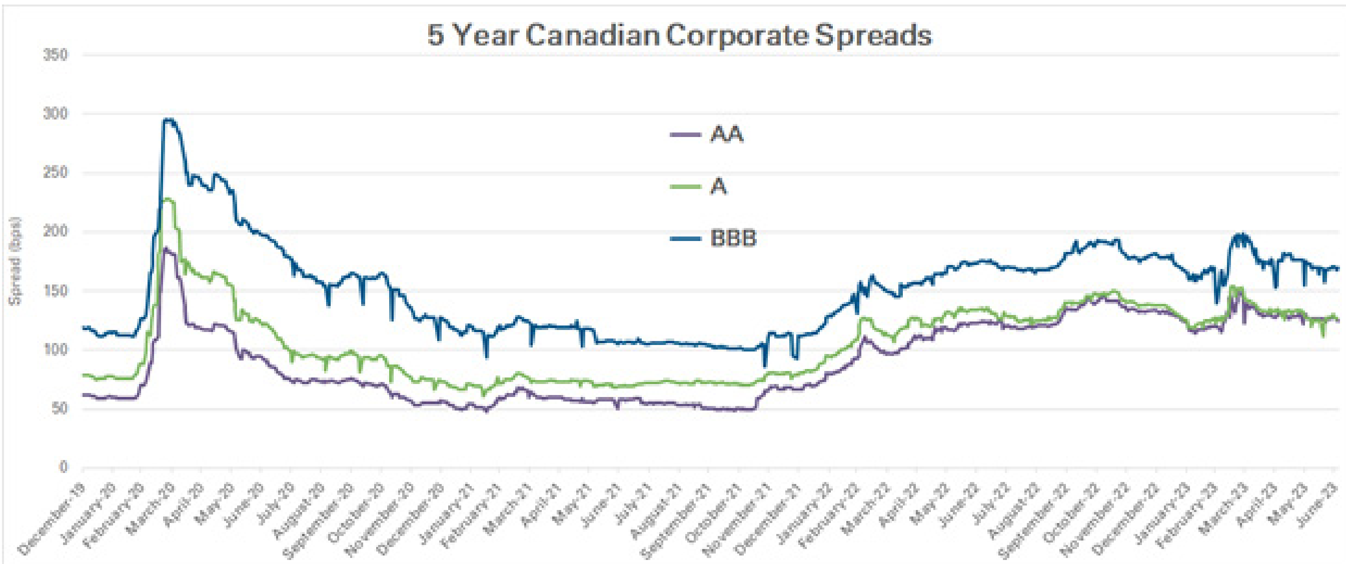


Source: Bloomberg

The unemployment rate, at 5.2%, while rising slightly above the low of 4.9%, sits well below the long-term average rate of 7.0%, as shown in the chart above. It is hard to envision a deep recession with such strong employment bolstering the economy.

Secondly, corporate bond spreads are one indicator of financial stress, and these remain well below levels commensurate with recessionary fears:

5-Year Corporate Bond Spreads



Source: BMO Capital Markets

As we mentioned, we recognize recession risk has risen to a degree. As such, in regards to credit, we continue to focus on higher quality credit (e.g. federal, provincial and agency bonds), and on the corporate bond side towards investment grade issuers. However, we maintain a small weight in non-investment grade credits with attractive yields and opportunities.

All in all, it has been a solid first half of the year, and we remain constructive on fixed income as a place to allocate investment funds at this time.

Enjoy summer and with kind regards,
Owen Morgan
Portfolio Manager
Cumberland Income Fund
July 4, 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.