FIXED INCOME - THIRD QUARTER 2023

Fixed Income Markets Quarter in Review

Heading into the third quarter of 2023, the outlook for the economy gave investors a few reasons for a little optimism. Inflation had fallen very consistently for a year and measured 2.8% by the end June, not all that far off from the Bank of Canada's 2% target. The economy, although slowing (GDP growth decreased to 1.8% for the prior 12 months by the end of Q1, and to 1.1% by the end of Q2) was still producing positive output. In addition, the unemployment figures remained surprisingly robust, with the unemployment rate at 5.5%, the net change in the labour force remaining positive (employers were adding to their payrolls), and average hourly earnings measured above 5% (meaning wages grew at a rate greater than 5%).

However, in July and August, the downward trend in inflation reversed itself. The Consumer Price Index (CPI) accelerated to 4%, and Core CPI increased to 4.1% (Core CPI is a key inflation measure the Bank of Canada monitors). While higher energy prices and shelter costs (mortgage interest cost) experienced notable upheaval, the underlying acceleration was also significant in its breadth in these two months. For instance, Service sector inflation was up 12% (on an annualized basis) in July (nothing to do with supply chain issues, as those have largely been resolved), goods inflation surged in August (+7% on an annualized basis), and transportation (auto prices) did in both months (+11% on an annualized basis for those two months) as well. As mentioned above, wage growth also remained high, contributing to the heated inflation figures.

Reaction from the Bond Market

With inflation flashing warning signals, expectations that the Bank of Canada's hiking cycle was at an end were diminished, although perhaps not quite extinguished. The current market consensus on rates is loosely translated as 'higher for longer', i.e. interest rates will not be cut for a longer period of time than previously thought and will remain elevated in order to stamp out this latest inflationary flare-up. Given these new expectations for higher rates longer, the Canadian yield curve level (the general, overall value of rates across the curve) shifted higher in Q3, with the more pronounced moves occurring in the longer term tenors (encompassing the 7 year to 30 year bonds). This is shown in the Canada Yield Curve chart further below. Rates moved higher by an average of 46 bps across the curve. The longer tenor bonds' yields increased over 70 bps. As bond investors, you know that when interest rates (yields) rise, bond prices fall, albeit modestly in this case.

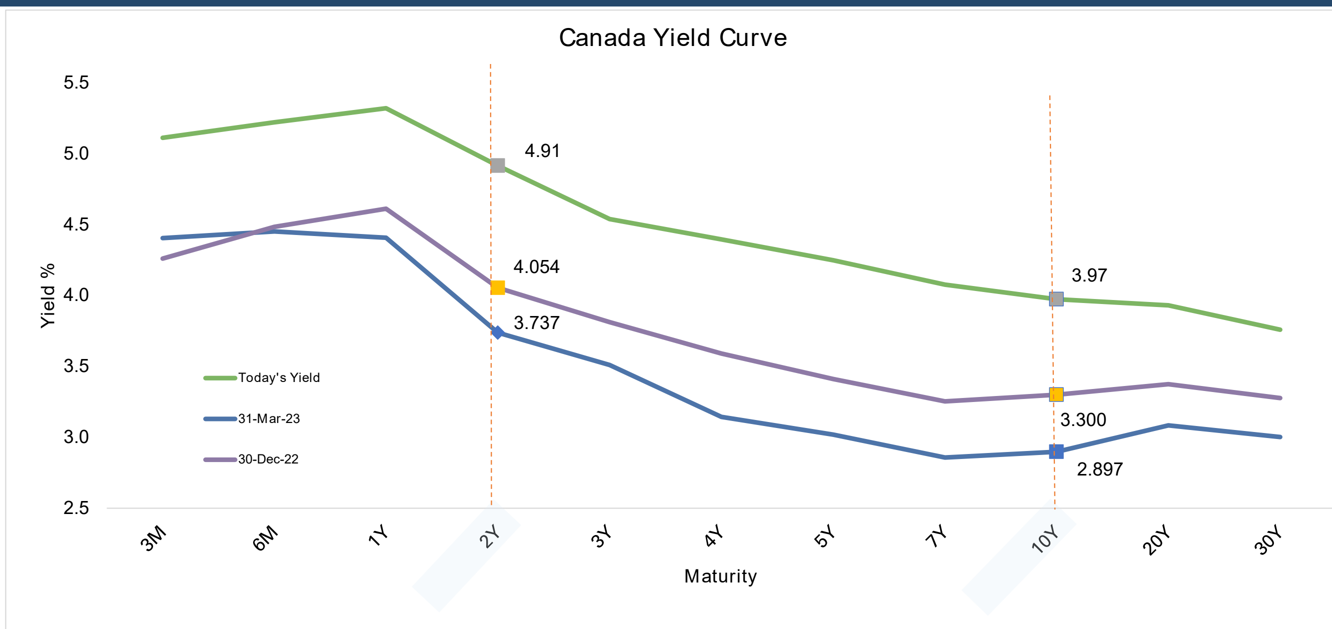
Returns for Fixed Income Asset Classes

Asset Class Returns	Q3 2023	YTD 2023
FTSE Canada Universe Bond Index	-3.87%	-1.46%
FTSE Canada Corporate Bond Index	-2.22%	0.69%
FTSE Canada HY Bond Index	1.27%	3.87%

Source: Bloomberg

The slope of the curve flattened to a degree, but remains inverted, with higher rates at the short end of the curve. The spreads between the 2-year and 30-year bonds' yields narrowed further from -149 bps to -115 bps. In other words, 2-year bonds currently offer 1.15% more yield now than 30 year bonds do, vs. 1.49% difference at the end of June. The 2-year and 5-year spread moved from -90bps to -66bps, or 0.24% narrower. Typically, longer-dated bonds offer investors more yield given the additional risks inherent in lending money over a longer time frame. The yield curve is normally (but not always) a gently upward-sloping line from left (shorter dated bonds) to right (longer dated bonds) across the maturity spectrum.

Canadian Yield Curve



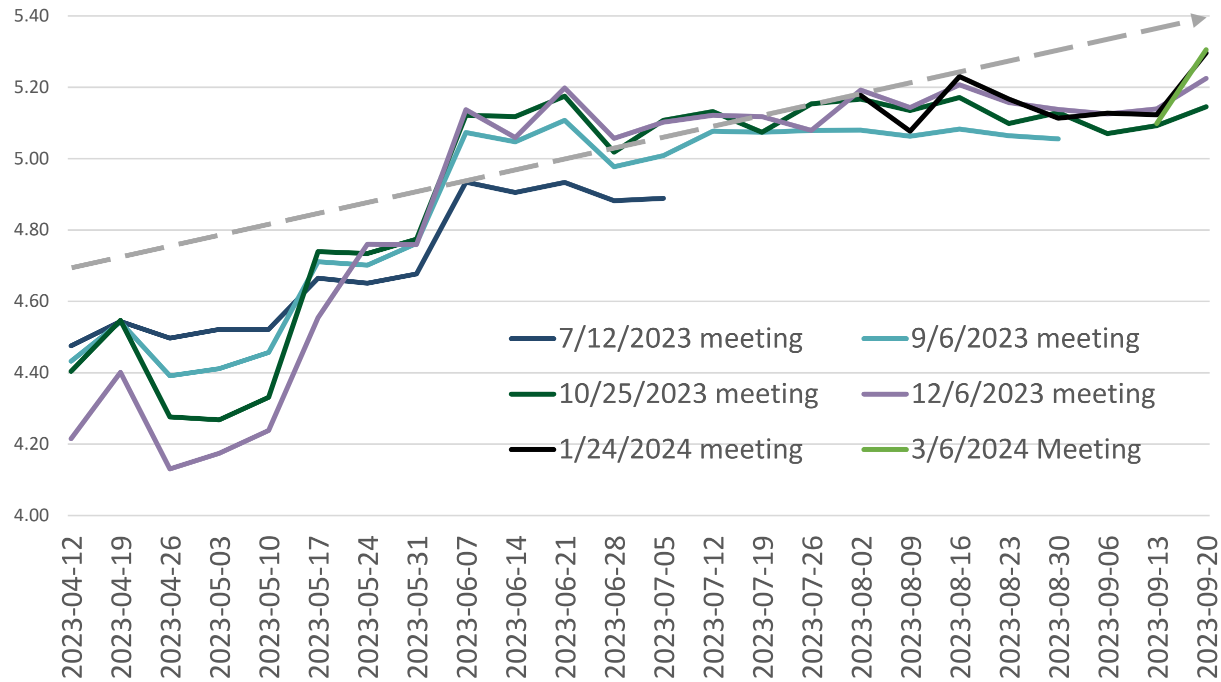
Source: Bloomberg

Where are interest rates headed?

The Bank of Canada opted to maintain the overnight rate target at its last meeting on September the 6th, which was prior to the receipt of the latest economic and inflation data. As noted by the market, the most recent inflationary figures certainly increased the likelihood of a rate hike at the next meeting on October 25th. However, there is another CPI inflation report in addition to employment and wages data to come before then.

The market expectation for additional rate hikes has risen. As shown in the chart below, the implied Policy Rate has risen over the course of the last couple of weeks after seemingly plateauing in early/mid August. 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 5.22%. In addition, the line for the March 6, 2024 implied rate is 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 then.

Implied Overnight Rate by Meeting Date

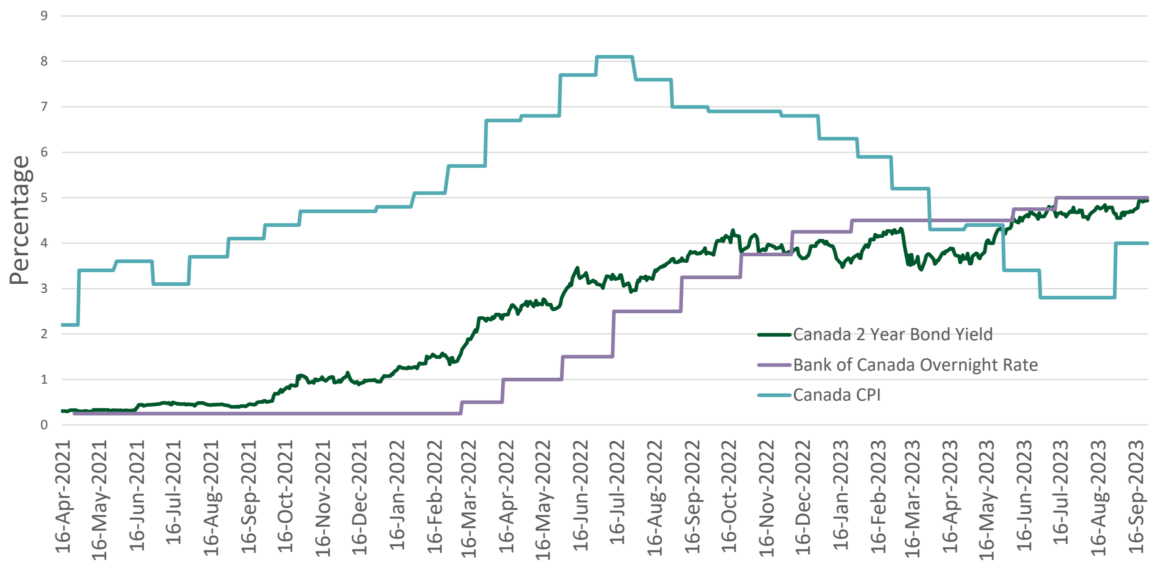


Source: Bloomberg

At present, the market believes there is a 25 bps interest rate hike remaining, although the timing of this is uncertain - the market believes the Bank of Canada will hike by a single 25 bps increment in one of the next three meetings, up to and including January 24th of 2024, bringing the target rate to 5.25%.

Our view remains that we are close to the end of the rate hiking cycle, with likely one more increase by year-end here in Canada. The possibility that rates will remain elevated for longer is looking more likely although this can change. 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 decrease towards the Bank of Canada's 2% target, although as July and August demonstrated, turbulence will be experienced along the way. Eventually, however, this will lead to a stabilization in interest rates. 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

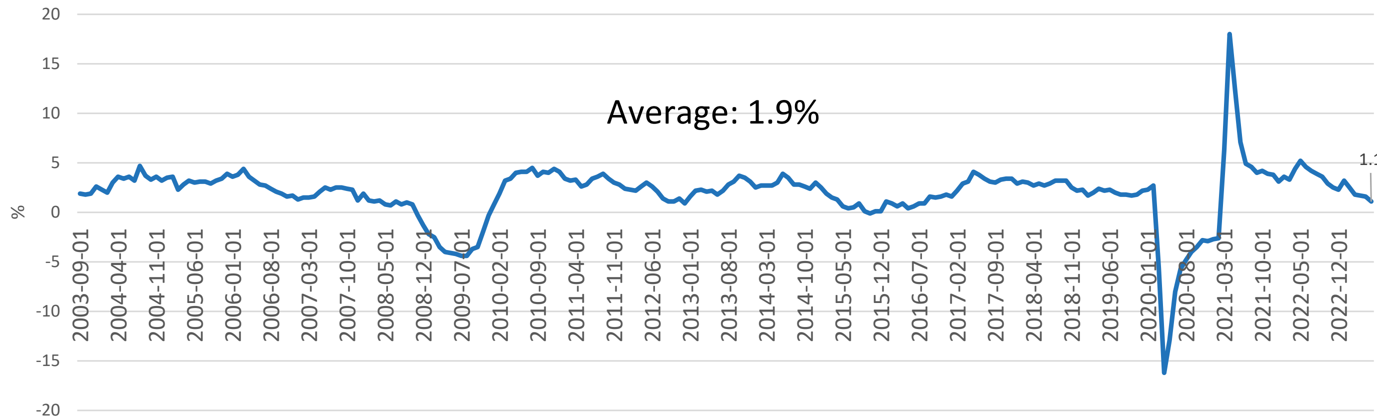
Given our expectations that the level of interest rates is likely to rise (by 25 basis points), the appropriate positioning is to decrease interest rate risk by keeping duration (a measurement of interest rate sensitivity) low, or below benchmark. If we believe the Bank of Canada will pause after hiking rates sometime in the next 3-4 months, and that the likelihood that rates will either decrease, or at least not remain static, in other words at high levels, for an extended period, 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. Yields are more compelling than at our last update a quarter ago. We see opportunities in existing issues that are trading below par, and therefore offer higher tax advantaged returns. In addition, new issues offer attractive coupons at present, with short-dated new issue bonds from some of the major Canadian banks offering ~5.5% coupon.

Other considerations

We also believe the odds of a recession occurring in Canada have risen since our last update. As mentioned above, economic growth as measured by year-over-year GDP growth has decreased fairly consistently since mid-2022, although we note it remains positive as of the latest readings.

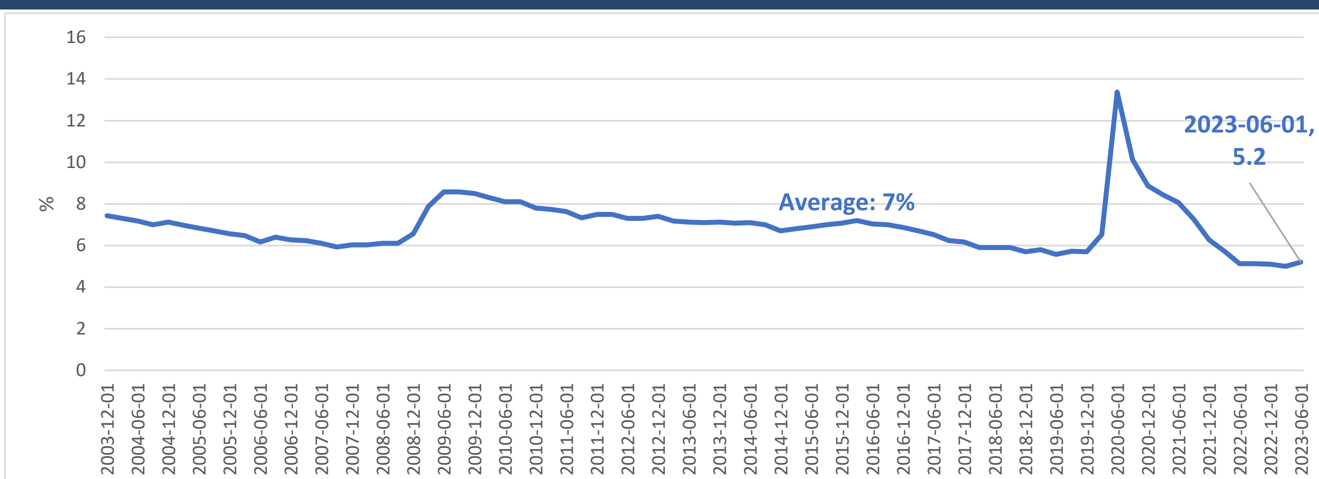
Canada: GDP Growth (year over year)



Source: Bloomberg

On a more positive note, the argument that a recession at the present time would likely be shallow, Canadians remain employed. The unemployment rate has risen modestly from its low of 4.9%, and currently sits at 5.2%, but this is well below the long-term average of 6.9%.

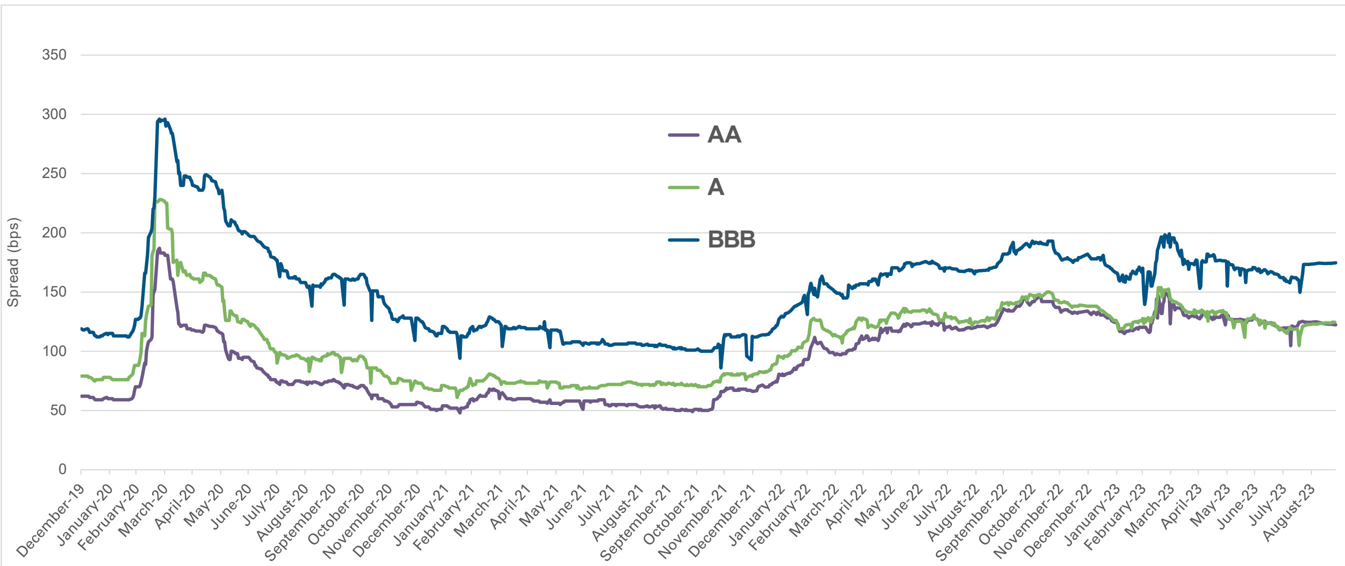
Canada: Unemployment Rate



Source: Bloomberg

In addition, as we have spoken of in prior notes, corporate bond spreads (the additional yield corporate bonds earn over Government of Canada bonds) are an indicator of financial stress on which we maintain a watchful eye. These spreads have tightened since the end of Q1, a positive sign (indicative of bullish sentiment towards corporate debt), and not near levels signaling a potential significant recession.

5-Year Corporate Bond Spreads



Source: BMO Capital Markets

These factors (GDP growth slowing, and sluggish; rising but still low unemployment; and corporate spreads remaining at or near long-term averages), indicate an increasing risk of recession, but not of a sharp slowdown in our view. As such, we maintain our credit focus on higher quality credit (e.g. some federal, provincial and agency bonds, and on the corporate bond side we lean towards investment grade issuers). However, we maintain a small weight in non-investment grade credits with attractive yields and opportunities. In addition, given the inversion of the yield curve, we continue to find many of the more attractive opportunities in the shorter-dated tenors (0-3 years). We believe the yield curve will slowly revert to its normal, upward sloping shape, however this may take longer than previously anticipated. In the meantime, yields are very attractive, as mentioned, and we remain constructive on fixed income as a place to allocate investment dollars.

With best wishes,
Owen Morgan
Portfolio Manager
Cumberland Income Fund

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