FIXED INCOME - FOURTH QUARTER 2023

Fixed Income Markets Quarter in Review

Well, 2023 was one of the most challenging years for fixed income investors with the converging challenges of combating inflation by governments around the world, regional wars, political instability, global warming and the impact and threat of economic recession all playing a role in determining what investors were looking for with respect to fixed income returns.

Despite a challenging first 9 months of the year, fixed income investors were rewarded for their patience in the final quarter of 2023, with the FTSE Universe Canada Bond Index gaining +8.27% for the quarter, bringing the YTD return to +6.69%. The rally in bond prices was remarkable in November (+4.29% for the month, the second largest monthly gain in over 20 years) and continued in December (+3.43%). There was outperformance in credit as well, helping further.

A confluence of factors we have previously discussed drove these returns.

The US released a string of more benign economic data, in the sense that it was slightly weaker than expected. This indicated, or hinted the economy was cooling after some robust data trends continued earlier in the year, despite the government efforts to lower inflation by raising interest rates, finally the rate increases were hitting the economy, suggesting the need for rate cuts, not further increases. This led investors towards their conclusion that interest rates had peaked, which drove the yield curve in the 10 year category down materially.

Canadian economic data was also mixed. For example, November produced a somewhat weaker jobs report (wage gains, while high, are moderating; most of new employment was in part-time work, etc.), and GDP was slightly negative. This caused the Bank of Canada to confirm it was holding the interest rate at its current level to further assess its impact on inflation and the economy.

Central bankers here, domestically, south of the border and in the ECB and UK as well, are all suggesting that interest rates had likely been raised sufficiently. The shift in their message was focused on a pause, while trying to dampen anticipation for rate cuts. However, the fixed income market ignored this cautionary tone and interpreted the comments as the signal to price in some meaningful interest rate cuts in the future.

In addition, the inflation data was positive in that inflation trended downwards, closer the central bank targets, after a couple of flare ups in the late summer. Declines in oil and energy prices contributed to this, but moderating trends are evident in most of the key consumer categories. While inflation remains above the central bank's target of 2%, the CPI figures here and in the US are now within striking distance of the target.

The bottom line is that the fourth quarter produced the lion's share of the returns for the calendar year for fixed income investors:

Returns for Fixed Income Asset Classes

Asset Class Returns	Q4 2023	2023
FTSE Canada Universe Bond Index	8.27%	6.69%
FTSE Canada Corporate Bond Index	7.63%	8.37%
FTSE Canada HY Bond Index	6.11%	10.0%

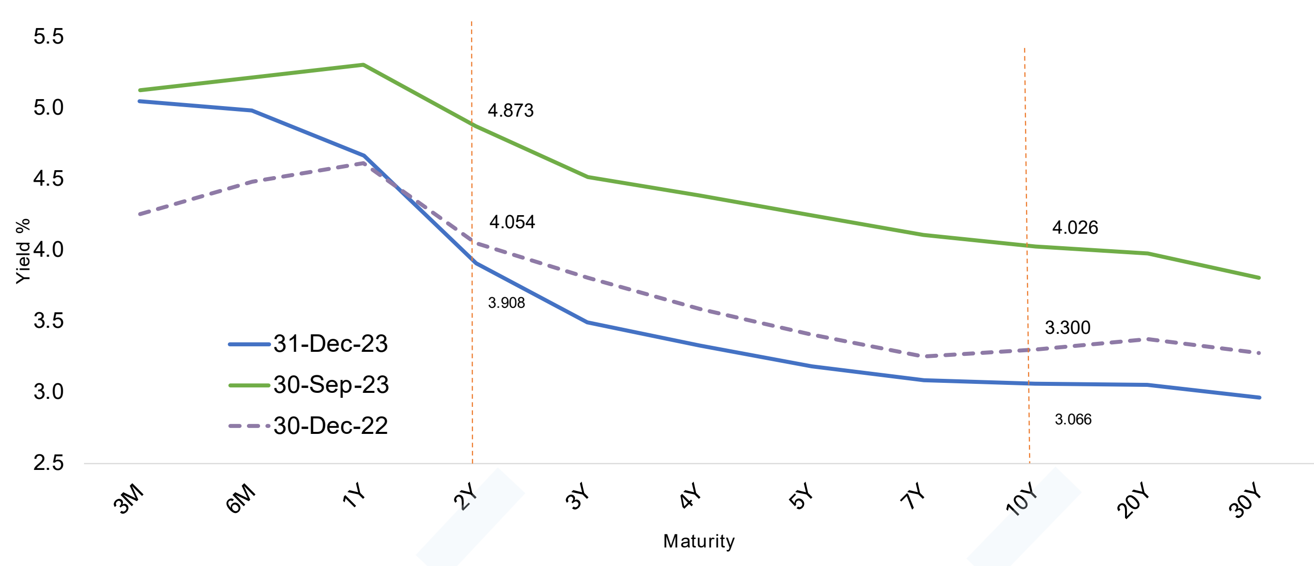
Source: Bloomberg

To illustrate the fairly significant move in rates experienced during the quarter, and how the yield curve reacted, you can see in the chart below that;

(1) the curve slope remains fairly sharply inverted (which is often interpreted as a sign that the economy will experience a recession in the short term), with short term rates higher than long term rates (for example, the 1- year bond rate of 4.7% is still significantly higher than the 10 year bond rate of 4.03%).

(2) the overall level of interest rates has decreased significantly. Both the 2-year and 10-year benchmark government bonds are almost 100 bps lower than they were at the start of the 4th quarter. This explains the significant investment performance of the bond indices above – as rates decrease, bond prices increase.

Canadian Yield Curve

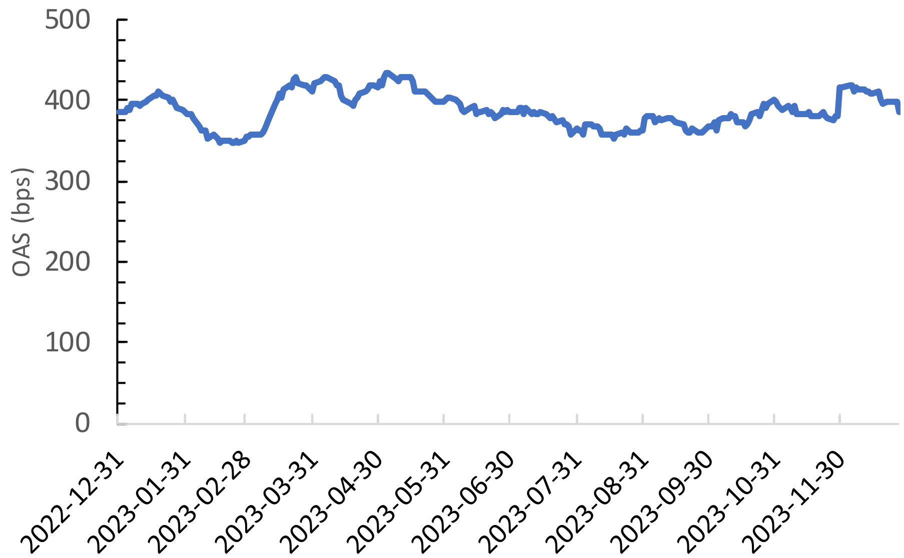


Source: Bloomberg

As mentioned above, credit performed well during the quarter, albeit not quite to the same degree the overall market did. When we refer to 'credit', we refer to fixed income securities that have risk specific to a borrower or counterparty and to the overall economy – the instrument's value may fluctuate due to those factors. Market risk refers to the risk that the security's value may fluctuate with changes in interest rates.

Credit spreads, or the difference in yield offered by a corporate bond versus a federal government bond, have remained fairly tight over the last year, despite the economic volatility. This means that the degree of risk that market participants assign to corporate borrowers has not changed significantly, despite the recent economic data we noted above. As shown in the chart below, spreads for non-investment grade bonds have fluctuated between roughly 350 and 430 bps throughout 2023 and ended at 400 bps. Not a huge amount of variability.

Canada High Yield Index
Spread over Government Bonds



Source: Bloomberg

2024 Outlook

We continue to believe that the fixed income market will be good for investors in 2024 with returns exceeding the rate of inflation and the opportunity to benefit from potential interest rate cuts by the central banks.

The market anticipates rate cuts sooner rather than later, as demonstrated by the move in rates experienced in Q4. As of this writing, the market pundits largely (85%) expect the first rate cut to occur by the Fed's March 20th meeting. My suspicion is that central bankers will be more cautious than widely anticipated in both the timing and pace of interest rate reductions, as they will be cautious to declare a premature victory in their fight against inflation. In our view, the first cut by the Fed will likely occur at the May or June meeting depending on how the economic data is trending. In either case, investors are receiving a nice return while waiting for the incremental bump that could occur with an interest rate decrease in 2024.

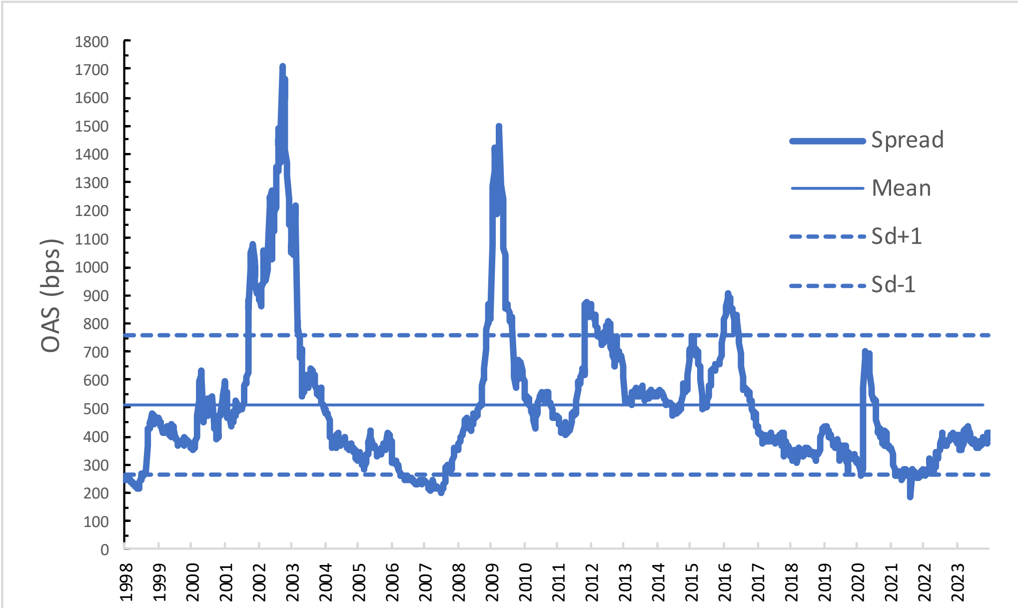
Focusing on Canada, with growth showing signs of stagnation, the unemployment rate rising, and noticeable (though unpredictable) improvements in managing inflation, the market is anticipating relief in Canada's spring interest rate commentary from the Bank of Canada. Again, our perspective remains that it will exercise caution, opting to maintain rates higher for a more extended period than the market is currently predicting. Again, this view stems from policymakers' desire to avoid underestimating the economy, including the underlying inflation pressures. However, it is my believe that the Bank of Canada will ultimately cut rates before the Fed does, largely due to the softer state of the domestic economy. As a result, my expectation is that the curve will continue to flatten over the coming year.

In terms of portfolio investment positioning, given the view that rate cuts are around the corner (or put another way, rate hikes are very likely to be in the rear view mirror), extending duration of the fund will be a benefit to the total return, if the anticipated rate cuts do materialize. Even in the absence of rate cuts, extending duration will not impact investors negatively should rates remain relatively static at current levels. The challenge, currently, is that short term rates remain above long term rates (as shown in the chart above, where the yield curve remains inverted). So extending duration will be balanced against the compelling rates on offer from shorter dated bonds and the trend in credit spreads until the yield curve normalizes to its more historic upward sloping direction.

This would likely mean modest increases in the fund weights in federal, provincial and/or investment grade corporate bonds. We will continue to have exposure to some non-investment grade credits, given their current attractive return prospects.

Despite the belief that the odds of a recession have risen, our expectation is that it will be of the mild variety. Unemployment, while rising, remains at or below long-term averages, providing a buffer against a consumer-driven shock to domestic demand. In addition, when rate cuts are announced, this should also help ease to a degree the mortgage-related stress on consumers and the economy. Finally, as we mentioned above, and often do in these quarterly notes, corporate bond spreads (the additional yield corporate bonds earn over Government of Canada bonds) are an indicator of financial stress that we monitor. These spreads tightened over the course of 2023, a positive sign (indicative of bullish sentiment towards corporate debt), and not signaling a potential significant recession.

High Yield Bond Spreads 1998-2023



Source: Bloomberg

In summary, absent a major unforeseen shock, we believe 2024 will provide a constructive environment for fixed income investors.

Happy new year and warm regards,
Owen Morgan
Portfolio Manager
Cumberland Income Fund

*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.