FIXED INCOME - FIRST QUARTER 2024

Fixed Income Markets Quarter in Review

Recall that in last quarter of calendar 2023 the yield curve decreased markedly (and as you readers and investors know, when yields drop, bond prices rise). The resulting bond price rally that occurred was the strongest quarterly return performance by Canadian bonds in over 20 years. At the time, some believed there was a reasonably good chance interest rate cuts by the Canadian and US central banks might start as early as March 2024.

It would be difficult to repeat such a strong performance, as a result, the first quarter of 2024 always had a tough act to follow and the bond market return performance was in fact a mixed bag. Interest rates drifted slightly higher (see Canadian Yield Curve chart below), which is a negative factor for bond return performance. Inflation continued to trend downwards at a slower than anticipated pace, but the Canadian economy remained stronger than expected with a very modest beat in GDP growth in January (the latest data released), thus creating the environment for mixed bag return profile.

For example, the Canadian inflation statistics released in mid-January indicated headline inflation (Consumer Price Index, or CPI) had accelerated from the prior month, but was in line with expectations. However, the Bank of Canada's preferred measures, the CPI Core Median and Trim measures (these two measures, broadly speaking, eliminate the most volatile components in the CPI measure with a view to give a clearer picture of overall inflation), were both not only higher than the prior month, but also running at higher levels than the Bank expected. Predictably the fixed income market reacted negatively to this news.

The impact from these results was the realization that while progress in the inflation fight continued, it did not proceed as much as expected, and some pricing volatility occurred. This in turn meant that the anticipated cut in interest rates by central banks would be delayed – known as the 'higher for longer' narrative we have previously noted.

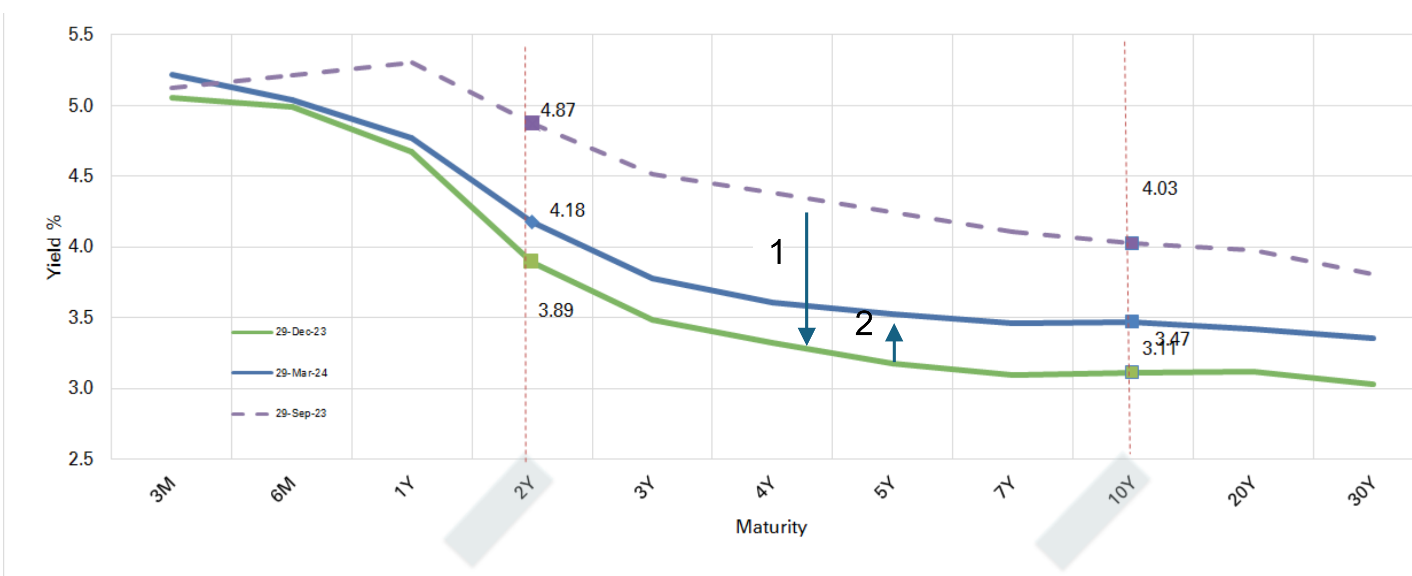
Looking at the Canadian Yield Curve chart below, which shows the yield curve across the investment time horizon as of the end of the third quarter of 2023 (the top, purple dashed line), at calendar year-end 2023 (the bottom-most green line) and at the end of the first quarter of 2024 (the middle blue line), one can see the impact of the market movements.

(1) The curve slope remains fairly sharply inverted , with short term rates higher than long term rates (for example, the 1-year bond rate of 4.87% is still significantly higher than the 10 year bond rate of 3.47%). Often this yield curve result can indicate that the economy is headed into a recession in the near term.

(2) The 2-year bond rate is heavily influenced by the Bank of Canada overnight lending rate, and once cuts commence, the rate should drop, and the more normalized view, an upward sloping curve, may occur.

(3) The overall level of interest rates has increased from calendar year-end 2023, by an average of +26 basis points. However, rates remain below those experienced at the end of September 2023 (in this case, by an average of -52 basis points).

Canadian Yield Curve

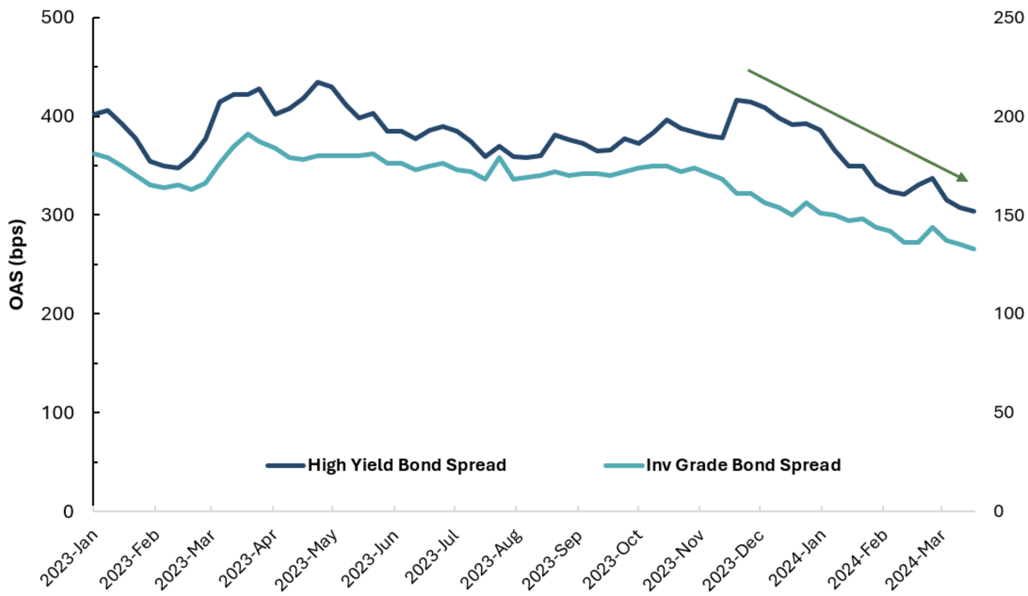


Source: Bloomberg

Investments with a credit spread performed well during the quarter and continued to outperform the overall bond market. 'Credit' refers to fixed income securities that have risk specific to a borrower or counterparty in addition to the overall economy – the instrument's value may fluctuate due to those factors. The other primary risk is 'Market' risk, which 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, tightened over the first quarter, reflecting confidence that economic activity had exceeded expectations, and that the economic outlook had improved somewhat. In effect, this is the market's way of saying that the degree of risk that market participants assign to corporate borrowers has decreased. As shown in the chart below, credit spreads for non-investment grade bonds here in Canada decreased by almost 90 bps in the first quarter of 2024, while credit spreads for investment grade bonds decreased by approximately 17 bps. When credit spreads tighten, bond prices increase, so this was a positive factor for corporate bond performance during the last quarter.

Canada Bond Indices Spread over Government Bonds



Source: Bloomberg

As a result, the bond market's performance in the first quarter reflected the slightly 'higher for longer' interest rate and spread compression themes. The overall fixed income market performance (which includes federal, provincial and municipal bonds in addition to corporate bonds) was slightly negative. The two corporate bond segments experienced positive returns for the quarter, particularly so for non-investment grade or high yield bonds as we can see below.

Returns for Fixed Income Asset Classes

Asset Class Returns	Q1 2024	2023
FTSE Canada Universe Bond Index	-1.22%	6.69%
FTSE Canada Corporate Bond Index	0.07%	8.37%
FTSE Canada HY Bond Index	2.96%	10.00%

Source: Bloomberg

2024 Outlook

The positive outlook for fixed income securities in 2024 we provided at the beginning of the year still rings true to us. We continue to believe that the fixed income market will be good to investors in 2024 with returns exceeding the rate of inflation and the opportunity to benefit from additional capital appreciation from potential interest rate cuts by the central banks.

In terms of the Cumberland Income Fund investment portfolio positioning, as we anticipate interest rate cuts in the near-term, it makes sense for us to start to extend the fund's duration, which will positively impact valuations when the interest rate cuts do materialize. As we wrote in our recent quarterly updates, with an inverted yield curve currently, the most attractive interest rates at the present time, are located at the short end of the yield curve, ie. the bonds closest to maturity, as short term rates remain above long term rates (refer to the Canadian Yield Curve chart above). Therefore, our decision to extend duration will be balanced against the compelling interest rate returns on offer from shorter dated bonds.

This would likely mean modest increases in the fund weights in federal, provincial and/or investment grade corporate bonds over the coming quarters. We will continue to have exposure to non-investment grade credits we identify that possess attractive risk-return profiles.

We continue to believe that the risk of a recession in Canada is low, but if one does technically occur, the impact will be mild. This view is supported by continued low unemployment figures, providing a buffer against a consumer-driven shock to domestic demand. Interest rate cuts should also ease the potential mortgage-related renewal stress on consumers and the economy.

Finally, as we mentioned above, corporate bond spreads are an indicator of financial stress that we monitor. As discussed above, these spreads tightened over the course of calendar 2023 and through the first quarter of 2024, a positive sign (indicative of bullish sentiment towards corporate debt), and not signaling any concern of a potential significant recession.

In summary, absent a material and unforeseen shock, we firmly believe the remainder of calendar 2024 will provide a constructive haven for fixed income investors.

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.