



CUMBERLAND

Private Wealth

FIXED INCOME - SECOND QUARTER 2024

Fixed Income Markets Quarter in Review

Following a challenging Q1 for interest rates, Q2 saw fixed income investments perform more positively. The tone of the interest rate cycle changed in June. First, the Bank of Canada cut rates by 25 bps on June 5th, to bring the overnight rate to 4.75%. This was the first cut by the Bank since the outset of the pandemic. The European Central Bank (ECB) followed suit the next day, cutting rates by 25 bps as well, to bring its headline rate to 3.75% (its first rate cut since early 2016).

The month of April saw income yields rise, as economic data, here domestically and from the US, provided evidence that inflation was continuing to prove tough to extinguish. For example, in early April, US ISM, which summarizes the economic activity in the manufacturing sector, was stronger, and prices paid by purchasing managers were higher than expected. The same reaction occurred again in mid-April and late April in response to higher than forecast US CPI (inflation) and US PCE (Personal Consumption) figures.

May saw a bit of reversal of this dynamic. Canadian inflation figures were slightly better than forecast, but GDP figures disappointed. The bond market's interpretation was that a weaker economy and high price pressures meant a reduction in the likelihood of interest rates remaining elevated.

June saw the shift in policy in Canada regarding the trend of interest rates change, but interestingly, returns were not quite as positive as the prior month. Stronger than expected payrolls in the US in early June were soon overtaken by disappointing employment and GDP figures, and rates fell as a result.

Looking at the Canadian Yield Curve chart below, which shows the yield curve across the investment time horizon from the end of 2023 (the green line), the end of the first quarter of 2024 (the blue line lying mostly at the top), and the end of the second quarter of 2024 (the dashed purple line), the movements resulting from the events and data above are shown. After moving higher in Q1, the yield curve flattened a little in Q2, with the short end rates declining while the longer dated ones remained relatively static.

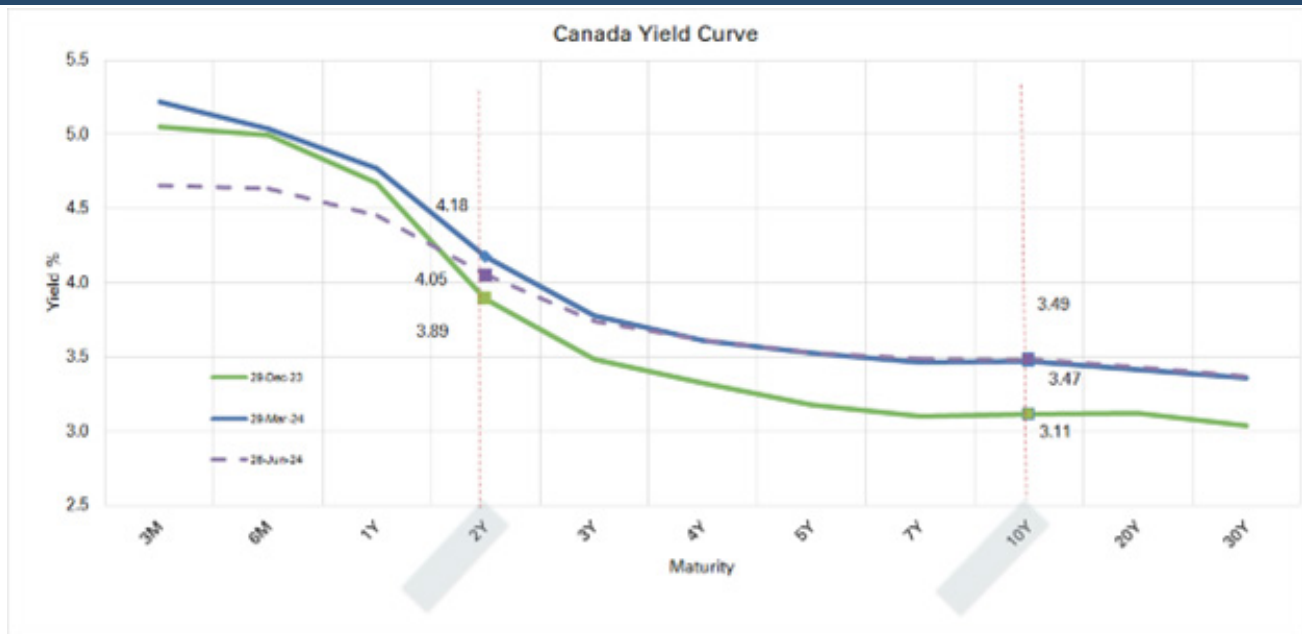
- (1) The curve slope remains inverted, with short term rates higher than long term rates (for example, the 1-year bond rate of 4.48% is still higher than the 10 year bond rate of 3.50%). This yield curve shape is often cited as an indication the economy may be headed into a recession in the near term.



(2) The very short-term interest rates (from 3 month to 2 years) are heavily influenced by the Bank of Canada overnight lending rate trend, and by the market's expectations of the timing of any changes to that rate. These all gapped downwards on June 5th, the day the BoC cut rates, but have not changed to a significant degree since.

(3) The overall level of interest rates has increased from calendar year-end 2023, by an average of +17 basis points. However, as mentioned above, these did not change materially from the end of Q1 for tenors of 3 years and higher (the average change in the quarter for these was 1 bp). The shorter term interest rates decreased (by an average of 37 bps over Q2 vs Q1, and by 13 bps on a YTD basis).

Canadian Yield Curve



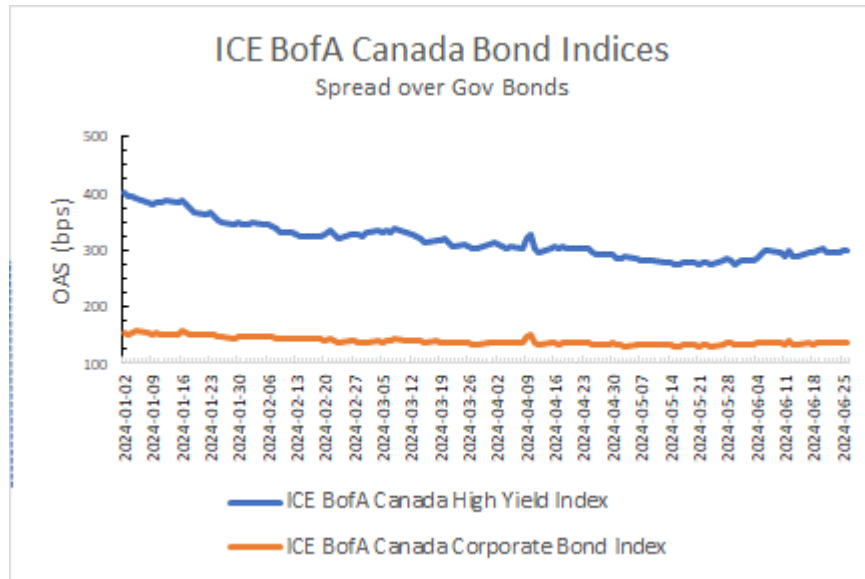
Source: Bloomberg

Another driver of fixed income returns are credit spreads, or the additional yield provided by corporate bonds over that of federal government bonds. Credit spreads narrowed very modestly over Q2, and remain well below year end 2023 levels, which is positive for returns (as spreads narrow, it means yields decrease, and as yields decrease, bond prices increase).

This reflected market participants' collective confidence that economic activity had exceeded admittedly low expectations, and that the economic outlook had improved somewhat. Said another way, the degree of risk that market participants assigned to corporate borrowers decreased. As shown in the chart below, credit spreads for non-investment grade bonds here in Canada decreased by 16 bps in the second quarter of 2024, while credit spreads for investment grade bonds decreased by a very modest single basis point.



Canada Bond Indices Spread over Government Bonds



Source: Bloomberg

In the second quarter, as shown above, interest rates were flat in general, and credit spreads tightened by a modest degree. The primary driver of this was the anticipation of the Bank of Canada’s first rate cut, which occurred in mid June. As a result, the overall fixed income market performance (which includes federal, provincial and municipal bonds in addition to corporate bonds) was positive. 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

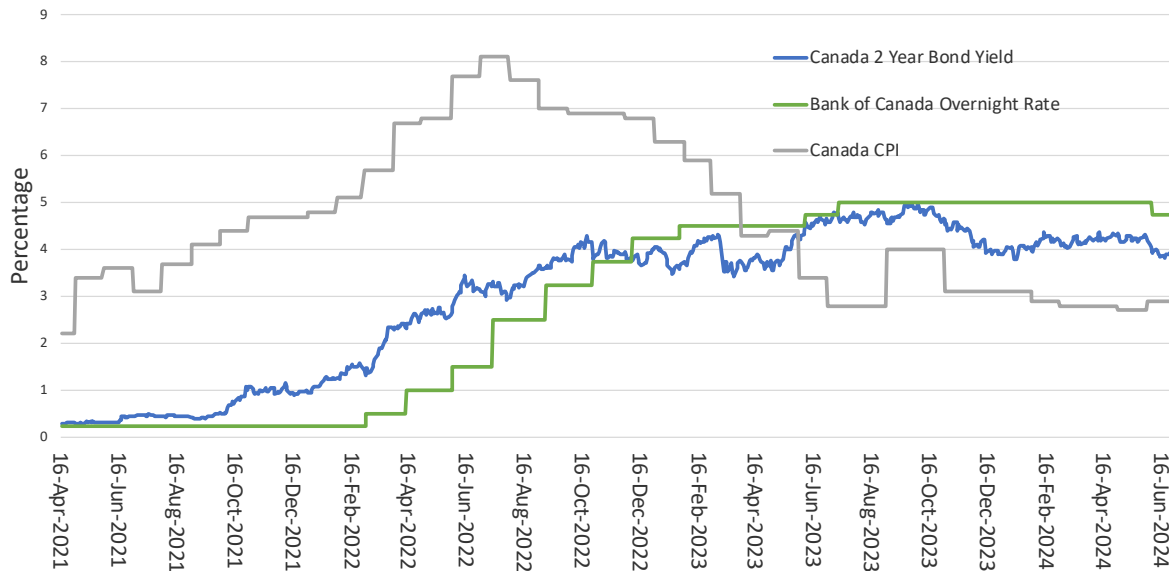
Asset Class Returns	Q2 2024	Q1 2024	2023
FTSE Canada Universe Bond Index	1.01%	-1.22%	6.69%
FTSE Canada Corporate Bond Index	1.18%	0.07%	8.37%
FTSE Canada HY Bond Index	1.51%	2.96%	10.00%

Source: Bloomberg



Outlook

Inflation, Interest Rates and Canada Bonds



Source: Bloomberg

We continue to believe the outlook for fixed income is positive for the remainder of the year. We believe we are at the beginning of a rate cut cycle by the Bank of Canada, although how deep the cuts and the length of time the bank will take to complete the phase is unclear. However, the chart above depicts the relationship between the rate of inflation (the grey line), the Bank of Canada's overnight rate (the green line), and the bellwether 2 year Government of Canada bond yield (the blue line). While not a perfect relationship, the rate of inflation and the Bank of Canada overnight rate should maintain at similar levels, and the 2 year bond yield is a good proxy for the market's expectation of the direction in which the overnight rate should head. You can see that as inflation climbed in 2021 and through mid-2022, the 2 year bond yield started diverging from the Bank of Canada rate soon thereafter. The Bank of Canada's response was late, and it had to hike aggressively in response. Currently, given both the rate of inflation and the 2-year bond yield are materially below the overnight rate, it seems logical that we can expect further rate cuts. At present the 2 year bond seems to indicate it may be 2 or 3 more cuts.

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 continue to extend the fund's duration, which will positively impact valuations as rates fall. As we wrote in our recent quarterly updates, with an inverted yield curve currently, the most attractive interest rate at the present time is 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 interest rate returns on offer from shorter dated bonds. Given the curve flattened somewhat during the quarter, this lessens the attractiveness of shorter dated instruments somewhat.



This likely means modest increases in the fund weights for federal, provincial, and/or investment-grade corporate bonds over the coming quarters. We will maintain exposure to non-investment-grade credits that we identify as having attractive risk-return profiles.

Finally, as mentioned earlier, we monitor corporate bond spreads as an indicator of financial stress. These spreads tightened throughout the first half of 2024, a positive sign and indicative of bullish sentiment towards corporate debt. It does not signal concern about a potential significant recession.

We believe the remainder of calendar 2024 will provide a positive outcome for fixed income investors.

Warm regards,
Owen Morgan
Portfolio Manager
Cumberland Income Fund

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