CUMBERLAND
Private Wealth

FIXED INCOME - THIRD QUARTER 2024

Fixed Income Markets Quarter in Review

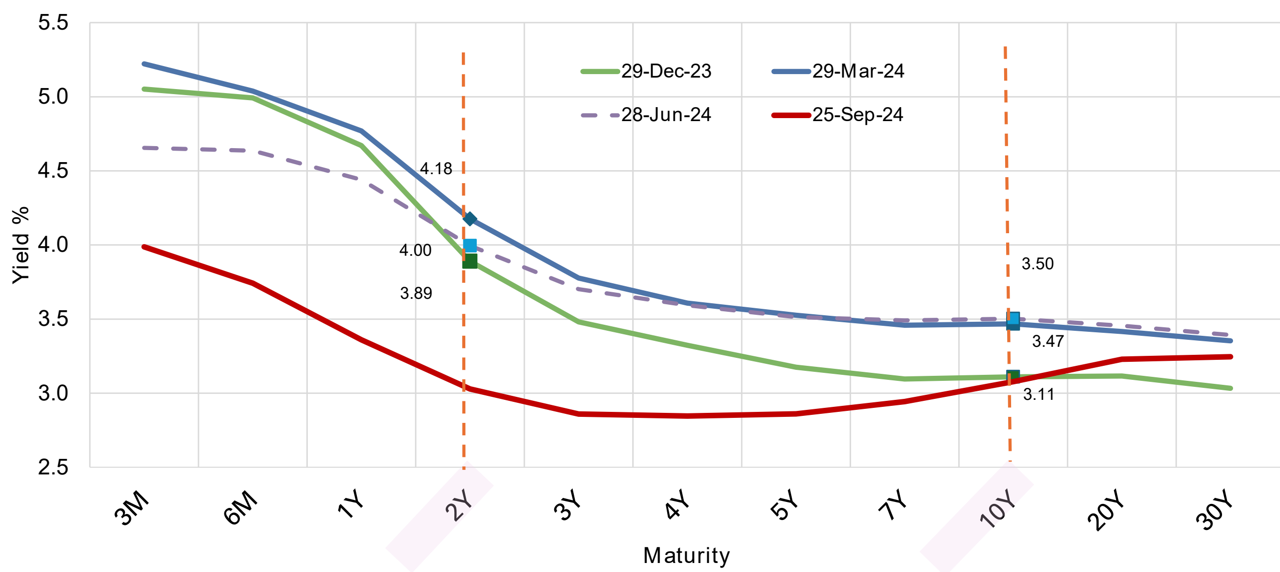
On June 5th, preceding the close of the second calendar quarter, the Bank of Canada cut the overnight interest rate by 25 basis points. This represented the first decline in the overnight rate following the beginning of the hiking cycle in March 2022, and the first cut in the overnight rate since March 2020. In the most recent calendar quarter, the Bank of Canada continued to ease interest rates, making cuts at both its July and September meetings by an additional 25 basis points in each instance. The Bank of Canada broadcast these moves ahead of time, and investors largely anticipated them. However, the market continues to believe that rates are heading even lower. The yield curve shifted downwards as a result of these moves over this period. A familiar theme in our recent commentaries is the reminder that when interest rates decline, the prices of fixed income instruments and securities increase. As a result, the third quarter was again a positive period for returns to fixed income investors.

In the two news releases and statements accompanying the interest rate cuts, the Bank of Canada cited the primary factors driving its decision. Economic growth remained positive, and slightly higher than anticipated (1.5% GDP growth in Q2), but noted that with the 3% growth in population, the output gap had grown further, and as a result, the economy is in excess supply – meaning it has slack, and demand is weaker than it might be. On a brighter note, it remarked that inflation continued to wane, and anticipated that this trend would continue, as it sees a decrease in pricing pressures across a majority of the categories it follows and measures. It also noted employment is weakening, although wage increases remained higher than it would like. As a result, with both growth (the economy) and inflation weakening, the Bank felt cuts in the overnight rate were appropriate.

The Canadian Yield Curve, as shown in the chart below, which shows the yield curve across the investment time horizon from the end of 2023 (the green line). It includes the end of the first quarter of 2024 (the blue line lying mostly at the top), the end of the second quarter of 2024 (the dashed purple line), and a very recent curve (the thick red line essentially at the bottom). Given the two rate cuts by the Bank of Canada and inflationary data suggesting prices pressures are waning, the yield curve moved in a downward trajectory. In addition, the curve flattened quite a bit.

First, during the quarter the curve moved downwards by an average of 72 basis points across all tenors, which is a powerful driver of the strong, positive returns bonds experienced over the period. Secondly, the move downwards was felt most sharply in short-term interest rates. The tenors of 3 months to 5 years saw their move downwards by an average of 89 bps. This is because these rates are heavily influenced by the Bank of Canada overnight lending rate (which as mentioned had two cuts of 25 bps apiece), and by the market's expectations of the timing of any changes to that rate. Finally, the curve remains inverted, with short term rates (specifically, the 3 month, 6 month rates and 1 year rates) offering higher yields than longer dated ones. This yield curve shape is often cited as an indication the economy is headed into a recession in the near term.

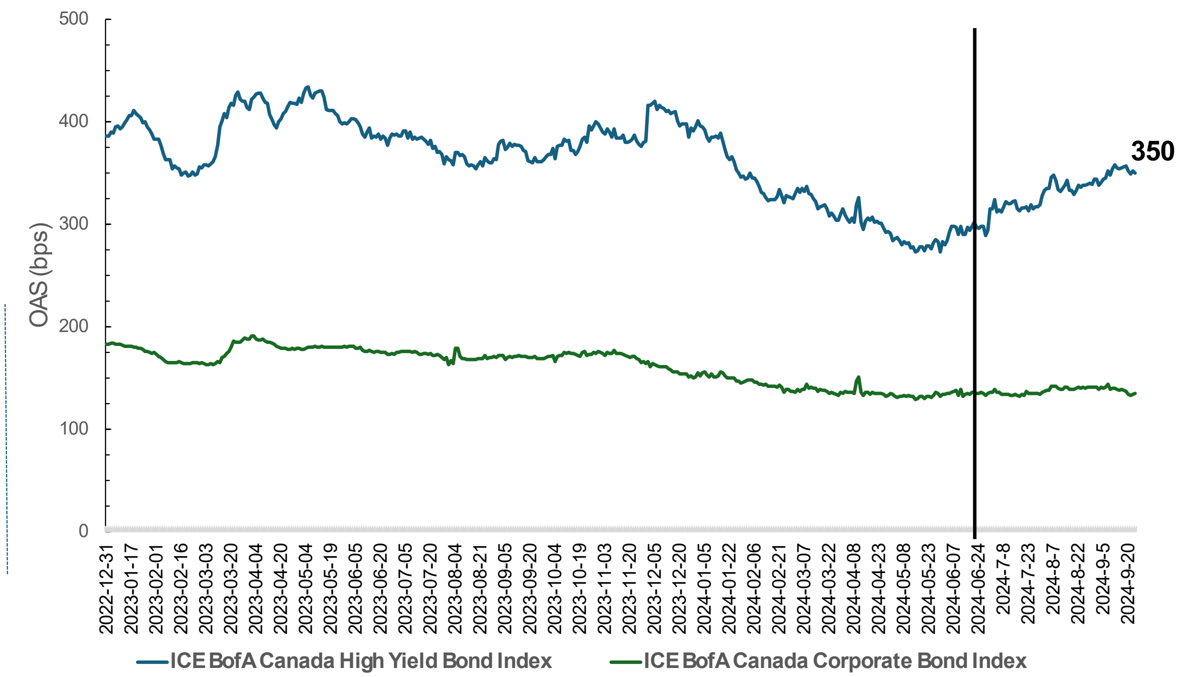
Canadian Yield Curve



Source: Bloomberg

Readers of previous updates will be familiar with another driver of fixed income returns, credit spreads, or the additional yield provided by corporate bonds over that of federal government bonds.

Canada Bond Indices Spread over Government Bonds



Source: Bloomberg

In the third quarter, as shown above, credit spreads drifted marginally wider. In the case of high yield bonds, from 315 bps to 350 bps, and in the case of investment-grade bonds, from 136 to 135 bps. Wider spreads dampen returns accordingly, so the impact to returns was mild. In addition, widening spreads can sometimes signal systemic financial stress, and as a proxy for (an increasing) market-wide level of fear. However, in this case, the difference in spreads is minor (essentially nil for Investment Grade bonds), and spreads of 350 bps (for high yield bonds) and of 135 bps (for investment grade bonds) are lower than the long-term averages of approximately 470 bps and 160 bps, respectively. Therefore, by this metric at least, the market is not telegraphing signs of distress or anxiety regarding the economy. Taking these two factors together, the move lower in rates, offset to a small degree by a slight widening in spreads, generated a strong, positive quarter for fixed income returns as shown below:

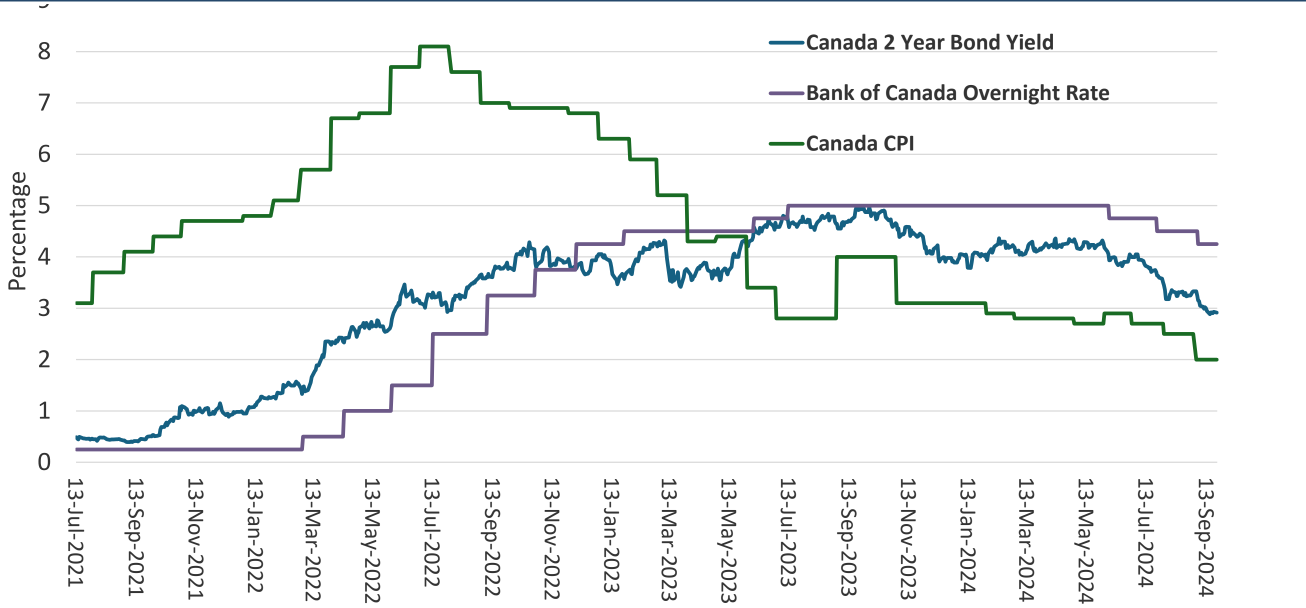
Returns for Fixed Income Asset Classes

Asset Class Returns	Q3 2024	Q2 2024	Q1 2024	2023
FTSE Canada Universe Bond Index	4.66%	1.01%	-1.22%	6.69%
FTSE Canada Corporate Bond Index	4.67%	1.18%	0.07%	8.37%
FTSE Canada HY Bond Index	4.02%	1.51%	2.96%	10.00%

Source: Bloomberg

Outlook

Inflation, Interest Rates and Canada Bonds



Source: Bloomberg

Looking at the chart above, you are likely familiar with it as we have shown it often before. It portrays the relationship between the rate of inflation, the Bank of Canada's overnight rate, and the yield of the government of Canada's 2-year bond. While they do not move in lockstep, the rate of inflation and the Bank of Canada overnight rate generally maintain similar levels. The 2 year bond yield is a good proxy for the market's expectation of the direction in which the overnight rate should head.

Inflation began its ascent in 2021 and continued to do so 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. More recently, inflation has eased, but while the Bank of Canada has cut rates three times, the overnight rate remains much higher than both inflation and the 2-year interest rate, by ~225 bps and ~125 bps respectively. This suggests that at present there may be few rounds of interest cuts by the Bank of Canada still to come.

We continue to believe the outlook for fixed income is positive for the remainder of the year and likely in very early 2025, absent unforeseen shocks. We believe we are in the middle of a rate cut cycle by the Bank of Canada, although the magnitude of the cuts in totality and the length of time the bank will take to complete this phase is still unclear.

In terms of the Cumberland Income Fund investment portfolio positioning, we anticipate further extension in the fund's duration given our view on near-term interest rate movements. If our outlook is correct, as rates decrease, our securities' valuation will react positively. We have written often in recent quarterlies that we try to balance the opposing forces between the attractiveness of near-term interest rates (with the continuing, yet waning, inversion of the yield curve, the highest 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), and the recognition that an investment opportunity also exists in benefiting from an anticipated decrease in interest rates by increasing the sensitivity to interest rates and extending duration (purchasing bonds with longer maturities for the most part). Therefore, our decision to extend duration will be balanced against the interest rate returns on offer from shorter dated bonds. Given the curve flattened to a degree (as shown above) during the quarter, this lessens the attractiveness of shorter dated instruments.

This translates into modest increases or fine-tuning of holdings in the fund's 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.

Indeed, with corporate spreads remaining relatively steady and below long-term averages, this does not suggest widespread anticipation of recession or of financial stress across the credit spectrum.

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.

CHART OF THE DAY

Central Banks worldwide are cutting rates simultaneously, as it appears inflation is approaching target levels in several countries and regions:

High Yield Bond Spreads 1998-2023

Ticker	Region	Country/Region	Next Release	Survey	Rate	1M Chg	3M Chg	6M Chg	1Y Chg
Africa (13)									
Asia Pac (8)									
RBATCTR	Asia Pac	Australia	2024/11/04		4.35y	--	--	--	+.25
BISPDHCH	Asia Pac	China			3.35y	--	-.10	-.10	-.10
HKBASE	Asia Pac	Hong Kong			5.25	-.50	-.50	-.50	-.50
INRPYLDP	Asia Pac	India	2024/10/09	6.50	6.50y		--	--	--
BOJDPBAL	Asia Pac	Japan			-.10y		--	--	--
NZOCR	Asia Pac	New Zealand	2024/10/08	4.75	5.250y		-.250	-.250	-.250
KORP7DR	Asia Pac	South Korea	2024/10/11	3.25	3.50y	--	--	--	--
TAREDSC	Asia Pac	Taiwan	2024/12/19		2.000y	--	--	+.125	+.125
Eastern Europe (11)									
Latam (4)									
BISPDHAR	Latam	Argentina			40.00y	--	--	-40.00	-78.00
BZSTSETA	Latam	Brazil	2024/11/06		10.75y	+.25	+.25	-.50	-2.50
CHOVCHOV	Latam	Chile	2024/10/17		5.50y	-.25	-.25	-1.00	-4.00
MXONBR	Latam	Mexico	2024/11/14		10.50y	-.25	-.50	-.50	-.75
Middle East (8)									
North America (2)									
CABROVER	North America	Canada	2024/10/23	4.00	4.250	-.250	-.500	-.750	-.750
FDTR	North America	US	2024/11/07	4.75	5.00	-.50	-.50	-.50	-.50
Western Europe (3)									
EURR002W	Western Europ	Euro Area	2024/10/17		3.650y	-.600	-.600	-.850	-.600
BISPDHSW	Western Europ	Switzerland			1.00y	-.25	-.25	-.50	-.75
UKBRBASE	Western Europ	UK	2024/11/07		5.000y	--	-.250	-.250	-.250

Source: Bloomberg

A few exceptions aside (Australia, Taiwan, and Brazil), a majority of the world's central banks cut rates over the past year as shown in the chart above. Even serial inflationary Argentina cut rates (admittedly following a serious hiking cycle). We view this as a generally positive driver for domestic rates given global trade and a sign inflationary pressures continue to ease.