# FIXED INCOME - FOURTH QUARTER 2024

## Fixed Income Markets Quarter in Review

The fourth quarter of 2024 witnessed inflation levels that fell within the Bank of Canada's target range, continuing interest rate cuts, political drama domestically, south of the border and abroad.

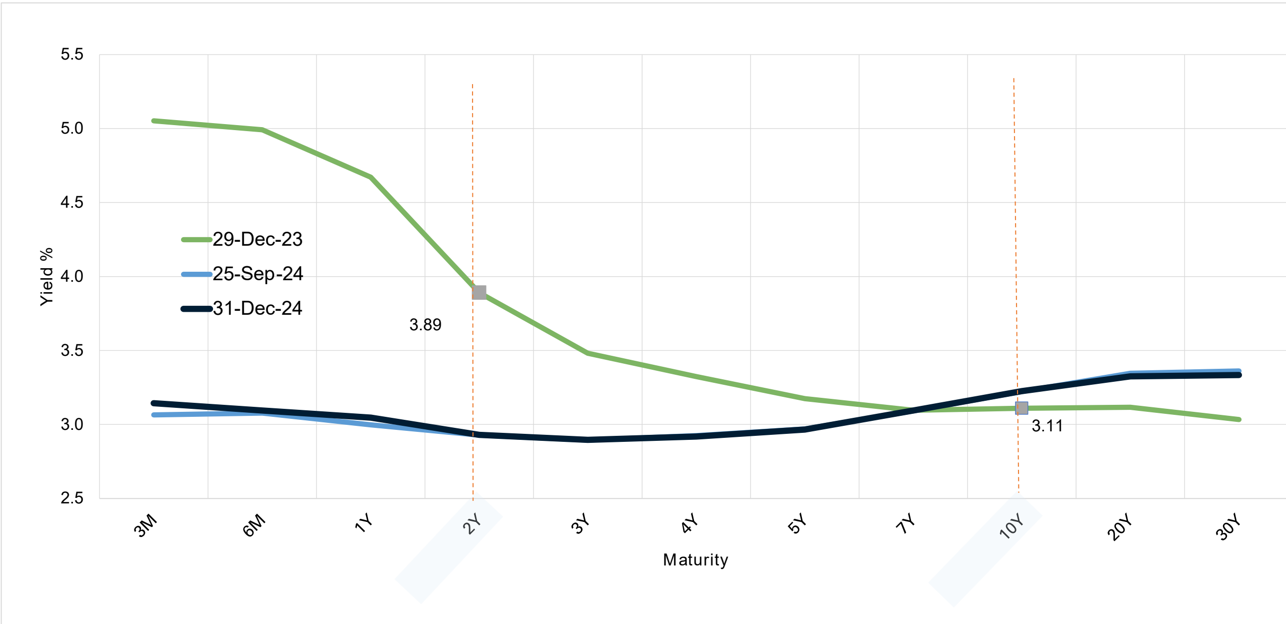
Decreasing economic growth, rising unemployment figures and the receding inflation trend, lead the Bank of Canada to cut interest rates twice during the quarter, by a 'jumbo' 50 bps each time, to bring the overnight rate to 3.25%, the lowest it has measured since October 2022. These cuts were expected by investors, and while the market largely believes further cuts will follow in 2025, it also believes we are closer to the end of the rate cut cycle than the beginning. But the year was a positive one for fixed income investments, and decidedly so for credit.

## Interest Rates

Looking at the chart below, the Canadian Yield Curve decreased and flattened over the course of 2024. We began the year with the curve inverted – this is the green line which largely sits at the top of the chart – with short term rates on the left higher than longer term rates on the right. For example, at the beginning of 2024 30-year bonds yields were approximately 80 bps lower than 2-year bond yields. With a total of five rate cuts in 2024 by the Bank of Canada, the curve flattened, meaning short term rates decreased (for example, the 2-year bond yield decreased by a total of 83.4 bps), while long term rates were stable or crept a little higher (the 10-year bond yield increased by 11.5 bps). We ended the year (represented by the dark blue line in the chart below) with rates in the 3-3.5% range across all tenors, and mostly upward sloping.

The chart also shows that interest rates in Canada did not fluctuate much in the fourth quarter of 2024. There is not a huge difference between the dark and light blue lines (the light blue line represents the yield curve as of September 30th, 2024, and the dark blue as mentioned above indicates the rates as at year-end). Rates did oscillate somewhat during the quarter, as markets wrestled with the ongoing rate cutting campaign, and increasing unease with potential trade issues resulting from the U.S. election result in early November.

## 1. Canadian Yield Curve



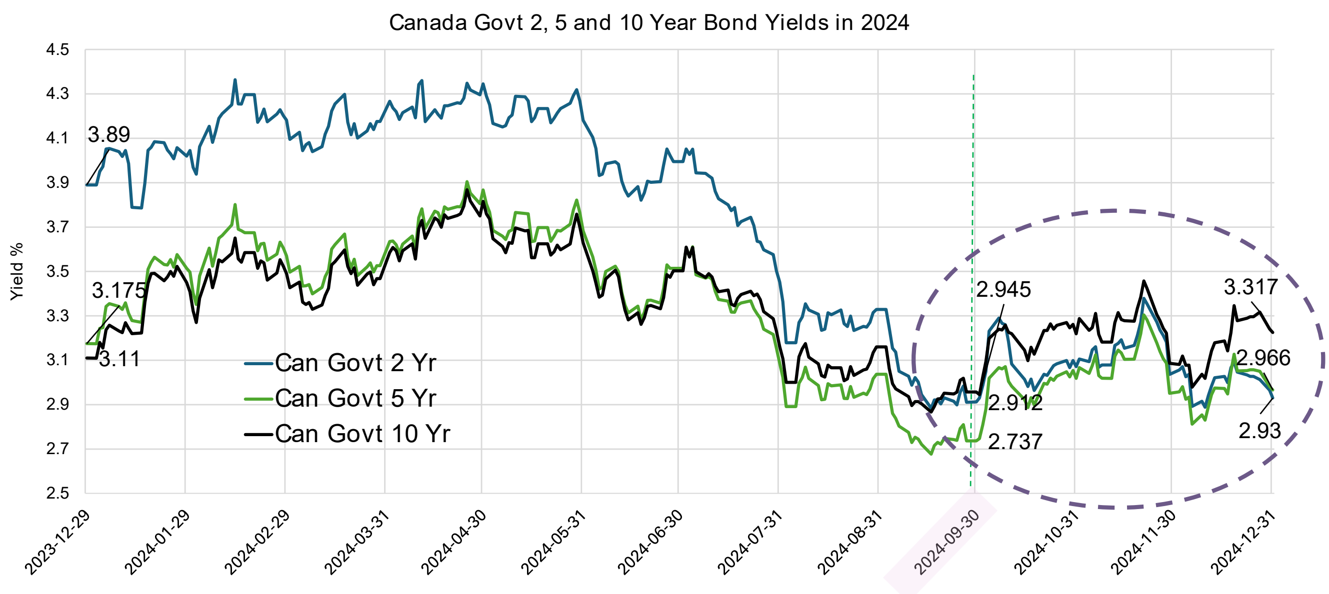

Source: Bloomberg

Chart 2 below, shows the 2-, 5- and 10-year bond yields over the course of 2024. The fourth quarter of the year, which is circled, shows that all three rates had drifted higher (by 45 bps or more) by mid-November, as the progress on inflation seemingly stalled. Rates then decreased through late November and early December, only to finish the year with rates on a bearish note as hawkish statements from the Fed accompanying its fourth rate cut of the year chilled expectations for the rate path in 2025.

Overall, as mentioned earlier, the rate curve flattened in 2024. The large move in the 2-year note was driven by the heavy influence of the Bank of Canada overnight lending rate (the five cuts cited earlier totaled 175 bps) and the market's expectations of the timing of any changes to that rate. In the fourth quarter, the 2-year note remained relatively unchanged (+1.8 bps), while the 5-year and 10-year rates increased modestly by 22.9 bps and 26.8 bps respectively.

The decrease in rates was a powerful driver for price appreciation in bonds and fixed income securities in 2024, and a very small headwind in Q4.

## 2. Canada Goverment Bond Yields

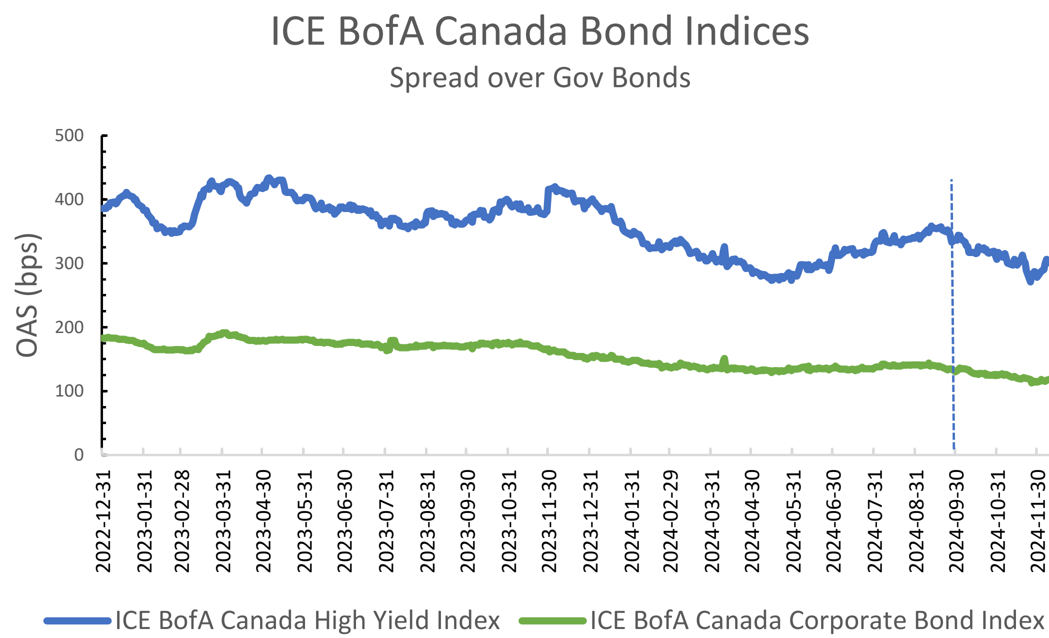



Source: Bloomberg

### Interest Rate Spreads

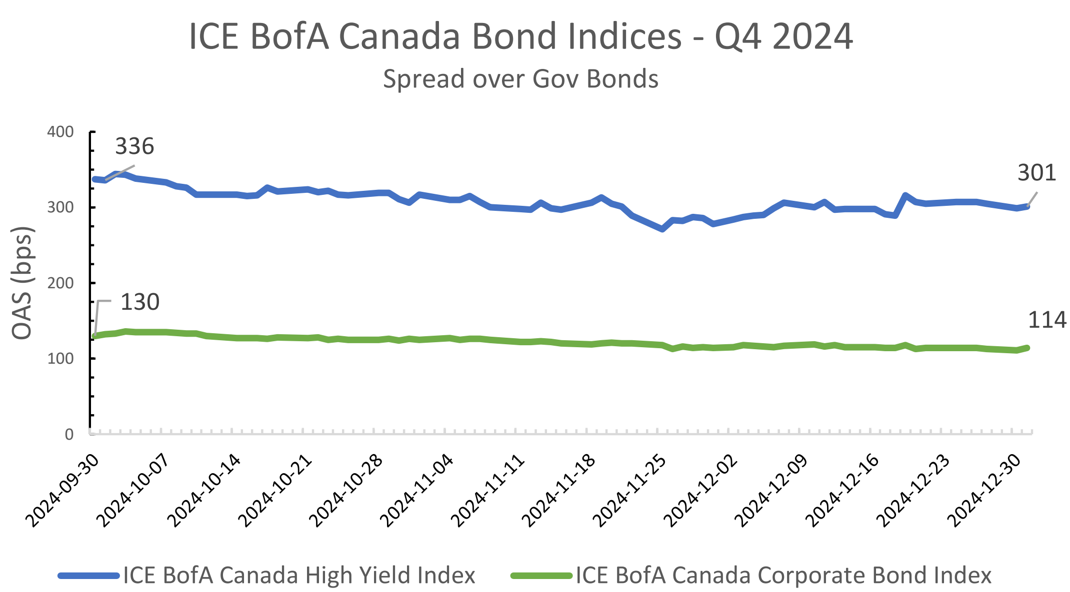
Readers of previous updates will be familiar with another driver of fixed income returns, namely credit spreads. This is the additional yield provided by corporate bonds over that of federal government bonds based on the assessment by investors of the risk of default differential.

## 3. Canada Bond Indices Spread over Government Bonds




Source: Bloomberg

## 4. ICE BofA Canada Bond Indices




Source: Bloomberg

Spreads tightened throughout 2024 as shown in Figure 3 above. In the case of non-investment grade bonds, credit spreads decreased materially, from 395 bps to 301 bps, while investment grade bonds decreased from 151bps to 114 bps.

In the fourth quarter, they tightened as well, as illustrated in Figure 4 above – non-investment grade spreads decreased from 336 bps to 301 bps, and investment grade spreads from 130 bps to 114 bps.

Overall spread decreases were driven by decreasing market-wide fears of financial stress, and therefore increasing comfort with corporate risk. The lower spreads were also driven by lower interest rate volatility and the rate cuts. As you are well aware, as interest rate spreads tighten, bond prices increase. Tighter spreads bolster returns accordingly, and therefore the impact to returns was beneficial.

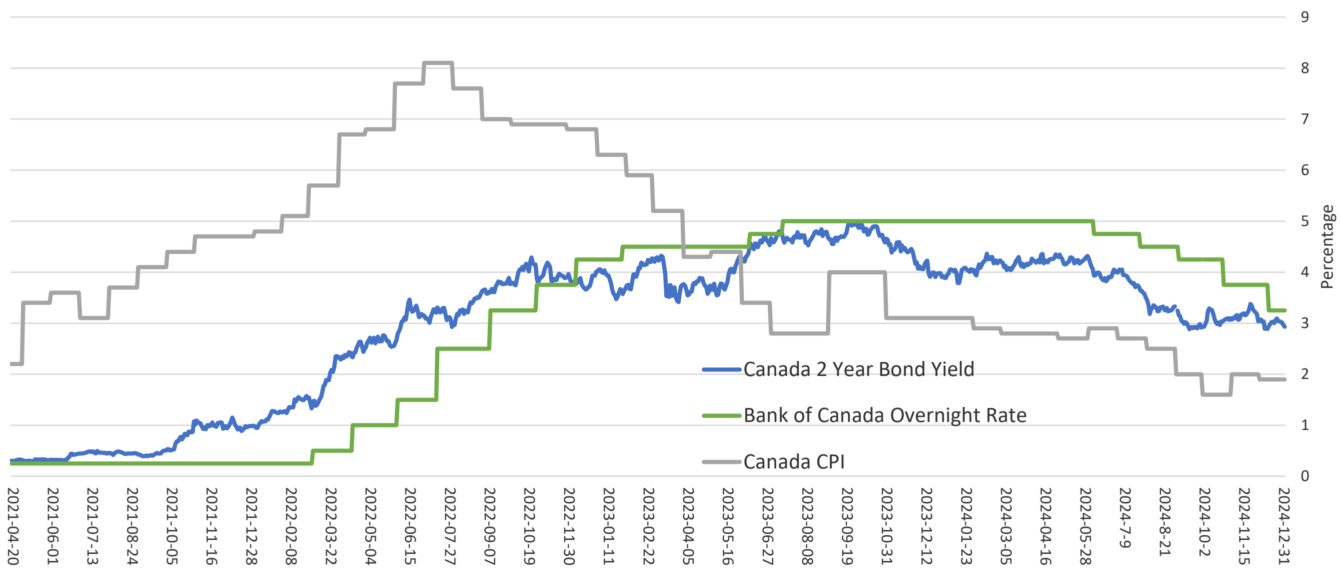
As a result, for 2024, taking these two factors together - the move lower in rates, and the tightening of credit spreads - generated a positive year for investors, particularly so for corporate bonds. In Q4, while interest rates backed up modestly, the spread tightening provided for positive returns for corporate bonds, as shown below:

5. Returns for Fixed Income Asset Classes

| Asset Class Returns | 2024 | Q4 2024 | Q3 2024 | Q2 2024 | Q1 2024 | 2023 |
|---|---|---|---|---|---|---|
| FTSE Canada Universe Bond Index | 4.23% | -0.04% | 4.66% | 1.01% | -1.22% | 6.69% |
| FTSE Canada Corporate Bond Index | 6.97% | 1.03% | 4.67% | 1.18% | 0.07% | 8.37% |
| FTSE Canada HY Bond Index | 11.48% | 2.52% | 4.02% | 1.51% | 2.96% | 10.00% |

Source: Bloomberg

## 6. Inflation, Interest Rates and Bonds




Source: Bloomberg

## Outlook

The chart above shows 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. The rate of inflation and the Bank of Canada overnight rate roughly approximate one another as a broad concept; however, this is by no means a perfectly correlated relationship - variability and divergence is not unusual. The 2-year bond yield is a good proxy for the market's expectation of the direction in which the overnight interest rate should head.

As shown above, inflation began to climb in 2021 and continued to do so through mid-2022 to levels not seen in decades. The 2-year bond yield started diverging from the Bank of Canada rate shortly thereafter, correctly interpreting the rising inflation trend as more than transitory. The Bank of Canada's response was late, and it had to hike aggressively in response to catch up. More recently, inflation has eased, but while the Bank of Canada has cut rates by 175 bps, the overnight rate continues to lie above both inflation and the 2-year interest rate, by ~135 bps and ~33 bps respectively. This suggests that the market expects further interest rate cuts by the Bank of Canada.

Looking at the year ahead, we believe the outlook for fixed income is generally positive, absent unforeseen credit shocks. We believe we are in the later innings of an interest rate cut cycle by the Bank of Canada, however there is still some uncertainty related to the total number of cuts, the timing and the magnitude. We do think that the yield curve will continue to normalize and return to an upward slope, where investors are rewarded for term risk. While corporate spreads are tight, it is currently our view that they will not widen materially in the short term given the economic backdrop (a sluggish but growing economy, with stabilizing unemployment) and the accommodative / loosening monetary policy of the Bank of Canada.

In terms of the Cumberland Income Fund investment portfolio positioning, we anticipate maintaining, if not extending, the fund's duration given our view on near-term interest rate movements. As rates decrease as we expect, our bond valuations should appreciate. We note that as a result of the flattening of the yield curve that occurred in Q4 as outlined above, short term rates remain more or less just as attractive as long-term rates. We will continue to weigh the risk-reward of potential price movements for longer duration assets versus shorter duration securities which offer essentially equivalent yields. In addition, as we believe corporate spreads are unlikely to widen to a significant degree, we will continue to maintain our exposures to credit. We also anticipate modest increases or fine-tuning of holdings in the fund's federal and provincial bonds as the credit cycle continues to mature. Lastly, we will maintain exposures to certain non-investment-grade credits that we identify as having attractive risk-return profiles.

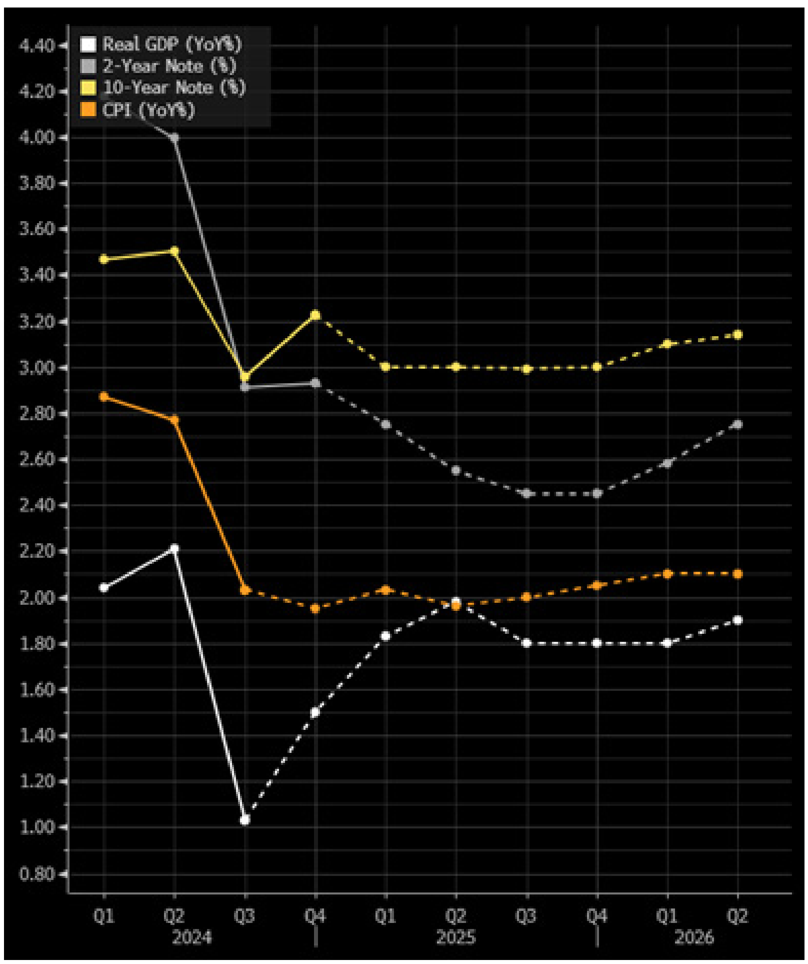
Warm regards and happy new year,
**Owen Morgan**
Portfolio Manager
Cumberland Income Fund

*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

Bloomberg aggregates the views of 21 separate economists / firms to provide a consensus projection of certain economic figures for Canada. The resulting consensus outlook is that (i) economic growth will be sluggish but positive and higher than the slump which occurred in Q3 2024, (ii) short term interest rates will decrease through the first half of the year, while the 10-year rate will remain more or less unchanged, and (iii) inflation will remain at current levels, which are at the Bank of Canada's target. We share many of these views and that these are generally positive drivers for domestic fixed income securities.

## Economic Projections




Source: Bloomberg