FIXED INCOME

First Quarter 2025 Review

Fixed Income Markets Quarter in Review

The stronger than expected Canadian economic performance in the fourth quarter of 2024 hinted at an inflection or a turning point for the country. Canada's GDP for Q4 increased by 2.6%, and inflation stayed in line with the Bank of Canada's 2% target for the second half of the year, suggesting increased stability. The interest rate cuts by the Central Bank (5 cuts through the end of 2024, encompassing a total of 175 bps) seemed to take root, spurring increased investment and economic activity. January seemed to confirm this trend, as GDP increased by 0.4%, its best performance in 11 months. The Bank of Canada again cut its overnight rate in late January by 25 bps.

However, the news from the United States, data trends and perhaps most importantly the uncertainty in recent weeks due to tariff threats indicates a new risk to this stability narrative.

The United States government's hard shift in fiscal, political and economic policies were the main story in the first quarter of 2025. From the viewpoint of a fixed income investor, there were two primary areas that impacted our outlook for the US economy. These are the proposed tariffs and the fiscal policy shifts. Tariffs, whether implemented or just threatened, came at a swifter pace and with a broader scope than anticipated. Fiscal policy also proved to dampen expectations (at least in the short term) to a degree as well, with sweeping government layoffs and proposed tax cuts. In addition, discussions continued on what the spending bill and limits might be continued during the quarter with only an interim solution implemented.

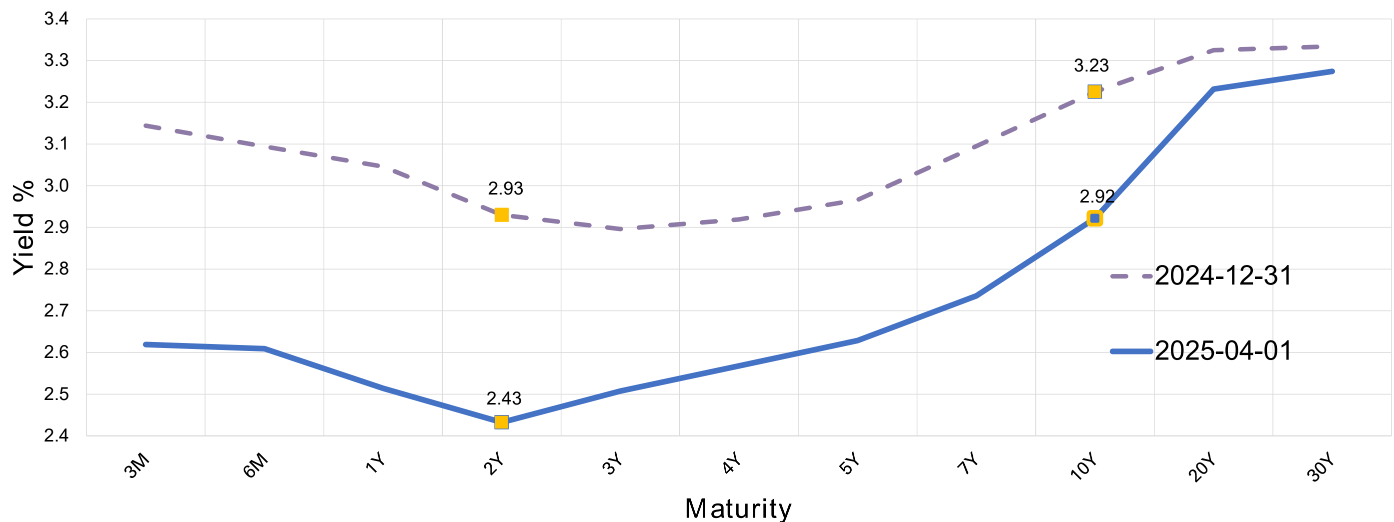
In addition to these two factors, lower immigration will also negatively impact economic growth, but only over the medium to long term. Lastly, deregulation in the US should help growth in the longer-term, although it will likely take time.

Putting aside these factors, the biggest impact felt during the quarter was the uncertainty and frequent changes in policies and announcements, causing businesses to pause on investment decisions given an increasingly opaque landscape.

Here in Canada, the year began on a hopeful note. However, the ongoing trade war and its chaotic nature took its toll on the outlook for domestic economic growth, and by extension the view of the future path of interest rates. Looking at **Figure 1**, below, over the quarter, expectations continually diminished that the tariffs the US government announced might not be enacted or would be modest in size and reach. As such, investors re-calibrated their estimates for the impact to the Canadian economy. Most economists predicted a recession

would be avoided, however growth would be unquestionably lower – as such, the short end of the yield curve shifted lower, in anticipation of further rate cuts by the Bank of Canada – note the Bank did oblige, twice, with their 25 bps cut in each of January and March. As seen in the chart below, the short end of the curve decreased by approximately 35-50 bps in the 3-month to the 2 year tenors below, while the 10-year and longer tenors moved very little if at all.

1. Canadian Yield Curve



Source: Bloomberg

The curve is almost fully upward sloping, meaning the shorter tenors yield less than the longer tenors, which is 'normal'. Investors expect higher yields for longer-term investments. In addition, the shorter terms are influenced heavily by expectations for monetary policy (in this case, likely anticipating accommodative policy), while the longer-term issues are more subject to fiscal and macroeconomic factors (perhaps expectations of growth and inflation).

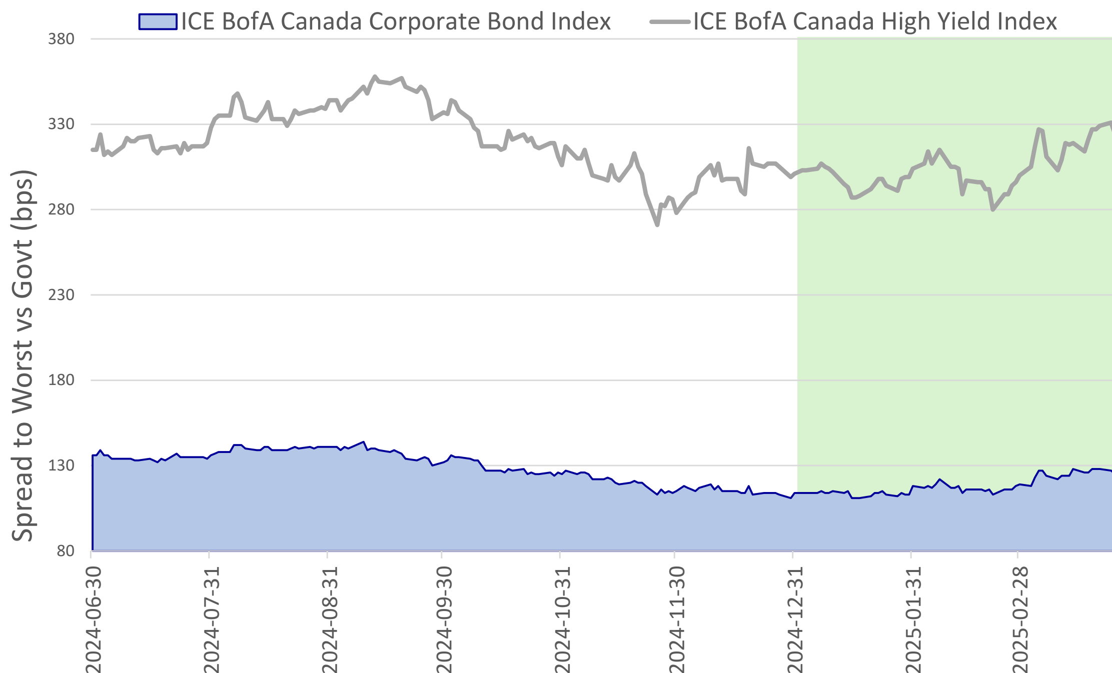
Falling yields however mean higher bond prices, and therefore this was a driver of positive fixed income performance during the quarter.

Interest spreads, after tightening through much of 2024, reversed course to begin 2025. However, the degree to which they widened was modest, limiting the impact on credit-sensitive fixed income securities.

Looking at the figure below, high yield spreads (the grey line at the top) widened from 301 bps at year-end 2024 to 328 bps as of this writing. This indicates that investors judged that the riskiness of non-investment grade bonds increased over the quarter. Accordingly, spreads of investment-grade bonds also widened, from 114 bps to 126. As spreads widen, bond prices decrease, and this had a modest negative impact on corporate bond

prices in the quarter. It bears noting that spreads of 328 bps and 126 bps for high yield and investment grade bonds respectively are below historical averages and still not at levels indicating recession much less credit quality concerns.

2. Canada Bond Indices Spread over Government Bonds



Source: Bloomberg

Fixed income securities enjoyed a positive start to the year. This was driven by the move lower in interest rates illustrated above. Credit-sensitive issues such as corporate bonds were positive as well, although not to the same degree as government bonds, due to the widening of interest rate spreads.

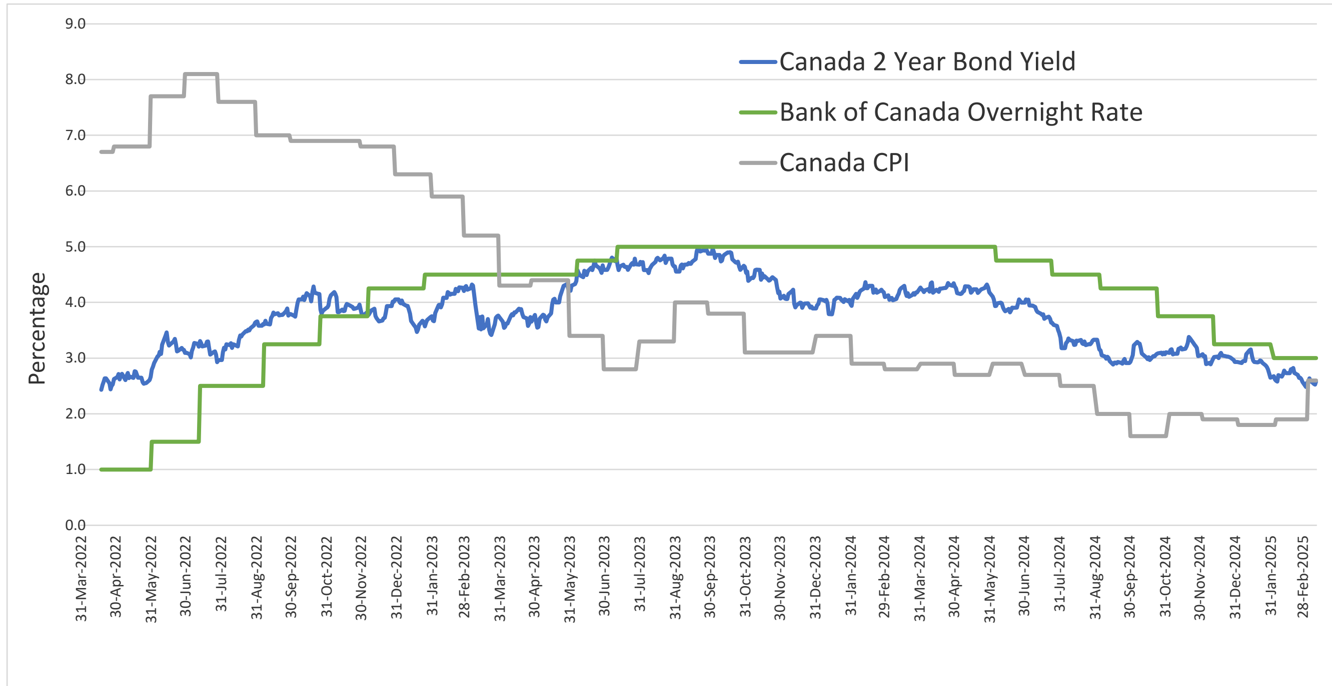
3. Returns for Fixed Income Asset Classes

Asset Class Returns	Q1 2025	Q4 2024	Q3 2024	Q2 2024	Q1 2024	2024	2023
FTSE Canada Universe Bond Index	2.02%	-0.04%	4.66%	1.01%	-1.22%	4.23%	6.69%
FTSE Canada Corporate Bond Index	1.81%	1.03%	4.67%	1.18%	0.07%	6.97%	8.37%
FTSE Canada HY Bond Index	1.24%	2.52%	4.02%	1.51%	2.96%	11.48%	10.00%

Source: Bloomberg

Outlook

4.Inflation, Interest Rates & Yield



Source: Bloomberg

The chart above **(Figure 4)** 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 was at or near the 2% target for the most recent six months through January 2025. In February, as the HST holiday expired, it jumped to 2.6%. If (or when) tariffs are enacted, they would add a one-time shock to inflation, but likely little to no longer-term effects. The 2 year bond yield moderated over the past six months, decreasing from 2.91% down to 2.5%. The Bank of Canada cut rates by 225 bps since June of 2024, to 2.75% at present. Taken together, inflation, the 2 year bond yield and the Bank of Canada overnight rate are within 25 bps of one another, suggesting limited scope for further interest rate cuts. However, despite the uptick in inflation in February, given the tariff war and the likely meaningful impact on the economy, we do believe that the Bank of Canada will cut rates before year-end.

We believe that the primary influence on financial markets in the coming months will be the trajectory of the global trade war. The announcement by President Trump on global tariffs, set for implementation on April 2nd, should set the tone for the next few months. If broad tariffs are imposed with few or no exemptions and

tariff rates are high, credit-sensitive assets could face a challenging second quarter. Conversely, if significant exemptions are granted or the U.S. continues to delay enforcement- much like it has with tariffs on Mexico and Canada- a relief rally in risk assets may occur. However, we believe economic growth will be impacted negatively given the damage inflicted so far. The key question remains whether conditions will deteriorate further and, if so, to what extent.

In terms of the Cumberland Income Fund investment portfolio positioning, we anticipate maintaining, if not extending, the fund's duration given our view on slower economic growth, and our expectation for near-term interest rates to move lower. If our view that rates decrease is proven correct, our bond valuations should appreciate. We will continue to weigh the risk-reward of potential price movements for longer duration assets versus shorter duration securities. In addition, as we believe corporate spreads are likely to widen moderately given the environment. Consumer weakness and company hesitancy to invest should pressure fundamentals. As such, we are unlikely to increase our exposures to credit currently. We also anticipate modest increases or fine-tuning of holdings in the fund's federal and provincial bonds. Lastly, we will maintain the exposure level to non-investment-grade credits that we have in the portfolio.

All in all, our inclination is to be defensive until there is policy clarity and we can get a read on the direction of the new Federal Government in Canada. This may take time, and there is likely to be tariff retaliation, government incentives, continued negotiations, new policies, among other actions.

Despite this noise, we believe rates (at least in the short to medium tenors) are heading lower, which is generally constructive for fixed income assets.

Owen Morgan
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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. 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.

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