

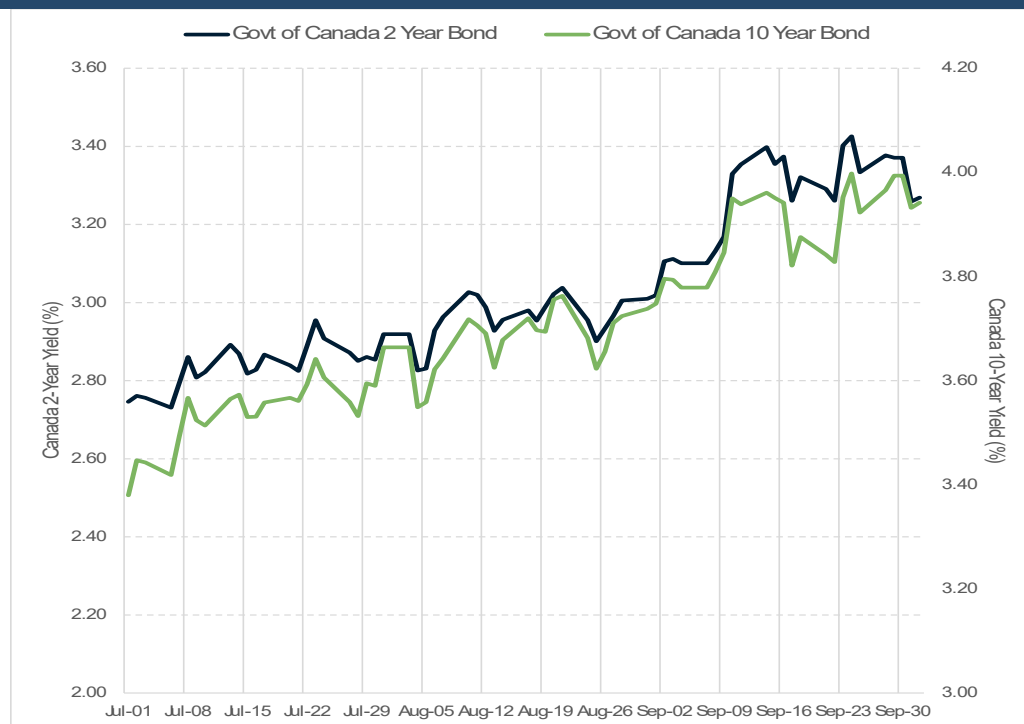


FIXED INCOME

Third Quarter 2026

The third quarter of 2026 was a challenging time for fixed income investors. Interest rates and the yield curve shifted higher over the period, in what can be described as an almost orderly manner (see Chart 1), a steady rise. For instance, the 2-year Government of Canada bond yield rose from 2.5% to 3.25%, and the 10-year yield rose from 3.55% to 3.95%.

1. Canadian Yields' Ascent in Q3



Source: Bloomberg

Drivers of rate increases:

- (i) **Energy Prices:** Conflict in the Strait of Hormuz pushed up global costs, increasing inflation.
- (ii) **Government Debt:** Many western countries, including Canada, are carrying high levels of debt, causing investor concern as rates rise.
- (iii) **Trade Tensions:** Ongoing trade disputes between Canada and the U.S. have created economic uncertainty.
- (iv) **AI Boom;** Huge investments in artificial intelligence have increased the demand for capital, pushing yields to higher levels.

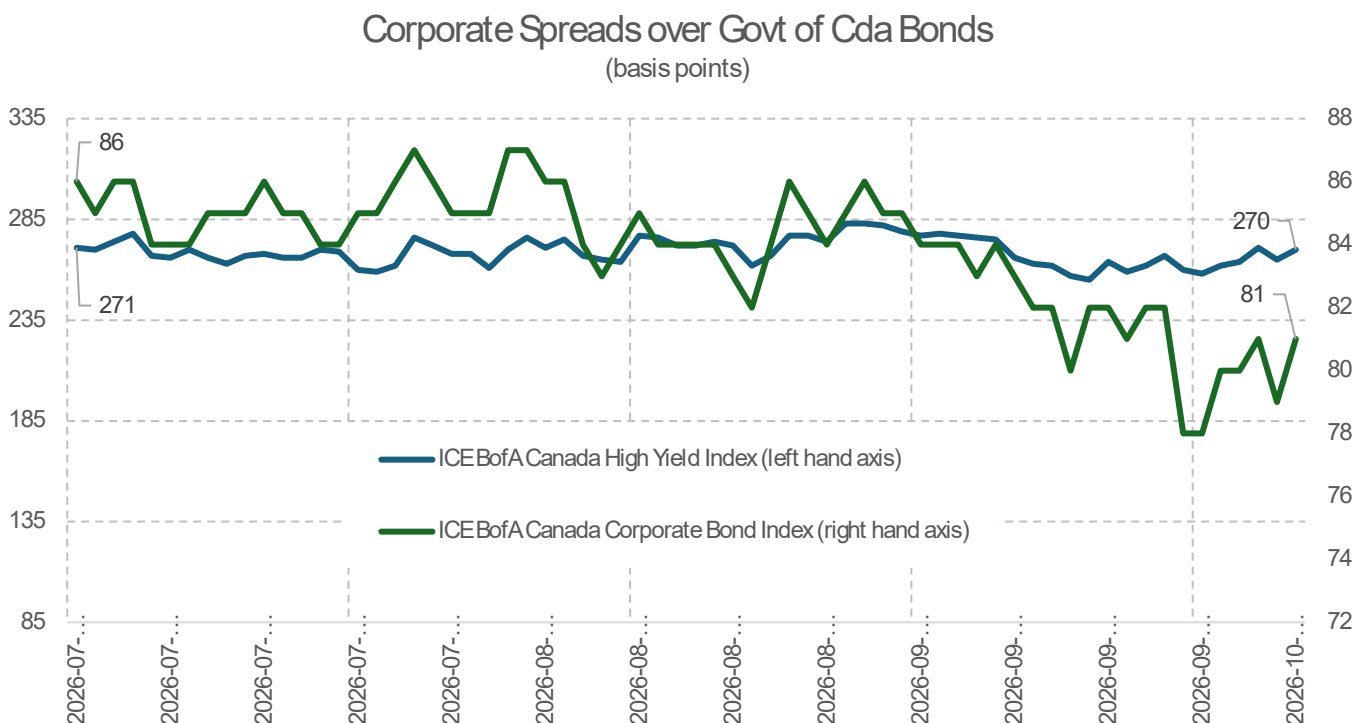


(v) We note that Canadian bonds felt the pull of rising global yields, but have mostly managed to remain calmer, especially recently. For example, U.S. 10-year Treasury yields are up 53 bps since the end of August while 10-year GoC yields are up 20 bps. They are now 135 bps below U.S. 10s, while not quite a record wide, is not far from the 151 bp extreme reached in January 2025 (as the first tariff threats were weighing). Canada's cooler growth backdrop, in part because of the trade tussle, slightly milder inflation, and less-fraught government finances have all played a role in dampening the yield back-up.

As you are aware, as bond yields increase, bond prices decrease, outlining why it made for a challenging period.

In more positive news, corporate spreads, or the incremental yield corporate bonds earn over the 'risk-free' federal government bonds, remained anchored. In periods of stress, these can spike, as occurred during the initial weeks of the covid pandemic, and in the early months of the Great Financial Crisis in 2007-08. However, spreads managed to tighten modestly during the third quarter, indicating investors are not sounding the alarm that the market is tenuous or fraught with peril (see Chart 2).

2. Canadian Corporate Bond Spreads in Q3



Source: Bloomberg



During the quarter, our strategy of holding primarily short-duration (or said another way, less interest-rate sensitive bonds), and on corporate issues served us well. These have performed better on a relative basis across most recent timeframes. They provided some protection in the form of lower duration as mentioned, and so did not bear the full brunt of the rise in yields. In addition, their higher coupons provide overall returns a buffer against falling bond prices (for example, a bond with a 6% coupon can fall in price by 5% but still provide a 1% return in a period of 1 year, while a bond with a 4% coupon can only decrease by 3% to still return investors that 1% return in the same time period).

3. Returns for Fixed Income Asset Classes					
Asset Class Returns	Q3 2026	YTD 2026	2025	2024	2023
Morningstar Canada Core Bond Index	-3.11%	-0.95%	2.29%	3.92%	6.32%
Morningstar Canada Corporate Bond Index	-2.42%	-0.24%	4.17%	6.60%	8.52%
Morningstar Canada High -Yield Bond Index	-0.01%	2.40%	7.16%	11.53%	8.45%

Source: Bloomberg

Looking ahead

In our Q1 and Q2 notes we outlined several factors underlying our outlook for the remainder of the year, and why they led us to believe the Bank of Canada would not hike interest rates:

- (i) the calm core CPI (which is not affected by volatile energy prices) will persist,
- (ii) domestic job growth remains weak,
- (iii) financial conditions are tightening,
- (iv) the higher oil prices rise, the greater the feedback into activity and employment, and
- (v) the looming CUSMA trade negotiations will continue to add uncertainty;

Many of these viewpoints remain valid today, but a couple have changed somewhat.

- (i) The August Core CPI measure of 2.4% has increased from a low of 2.1%, but remains within the Bank of Canada's target range and has decreased from the beginning of the year (2.8% at the end of December 2025). Despite this measure's exclusion of energy prices, the longer these (energy prices) remain elevated, the more likely these bleed into general prices as well, and this rises further to levels which spur the Bank of Canada into action.
- (ii) Job growth improved perhaps unexpectedly in the May-July period following a weak spring (the trailing six-month change in labour force employment climbed from -49.9k as of the end of April to +135.8k at the end of August).
- (iii) Financial conditions remain tighter than a year ago.
- (iv) The recent retraction in energy prices, if they persist, should benefit the economy, so this is the one point that is a potential boon to the nation.
- (v) Trade uncertainty continues to weigh on the economy, and US tariffs are now enacted on several Canadian goods, although the overall effect is limited so far, but more are scheduled to be in place by year-end absent an agreement.



On balance, we believe the uncertainty stemming from the ongoing trade frictions with the US will constrain growth and keep the Bank of Canada on the sideline. However, the threat posed by inflation from energy prices has increased, as noted by the Bank of Canada's Governor Macklem: "The longer oil prices and refinery margins stay high, the greater the risk that higher energy prices spill over and turn into persistent inflation." He added that "new US tariffs and the Canadian counter-tariffs could add costs for some businesses and feed into consumer prices over time". As a result, if inflation does rise further, we believe the Bank of Canada may be forced to raise rates sooner rather than later. This is not our base case viewpoint, however the likelihood this event may occur has risen in our opinion.

Portfolio Positioning

Our continued focus on bonds that are less sensitive to interest rate changes helped protect your investments. Higher interest payments (coupons) created a buffer that helped offset the decline in bond prices.

Outlook & Next Steps

We are "neutral" for the rest of 2026 due to market uncertainty, but we remain cautiously optimistic into early 2027.

Your portfolio is designed to generate reliable income while protecting you from unnecessary risk.

Warm regards,
Owen Morgan
Portfolio Manager, Cumberland Income Fund
October 8, 2026

Sources:
Bloomberg

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