CUMBERLAND
Private Wealth

FIXED INCOME - SECOND QUARTER 2022

The second quarter of 2022 echoed many of the themes evident in the first quarter. Inflation in both US and Canada exceeded already lofty expectations and climbed to levels not seen since the early 1980s. The Federal Reserve and the Bank of Canada hiked rates sharply and aggressively in response. Oil, a primary driver of inflation, hit multi-year highs as well, as the conflict in Ukraine entered a new, possibly more protracted stage, roiling energy markets. The impact to financial markets, although not as severe as the first quarter, was steeply negative across most asset classes.

Canada Update

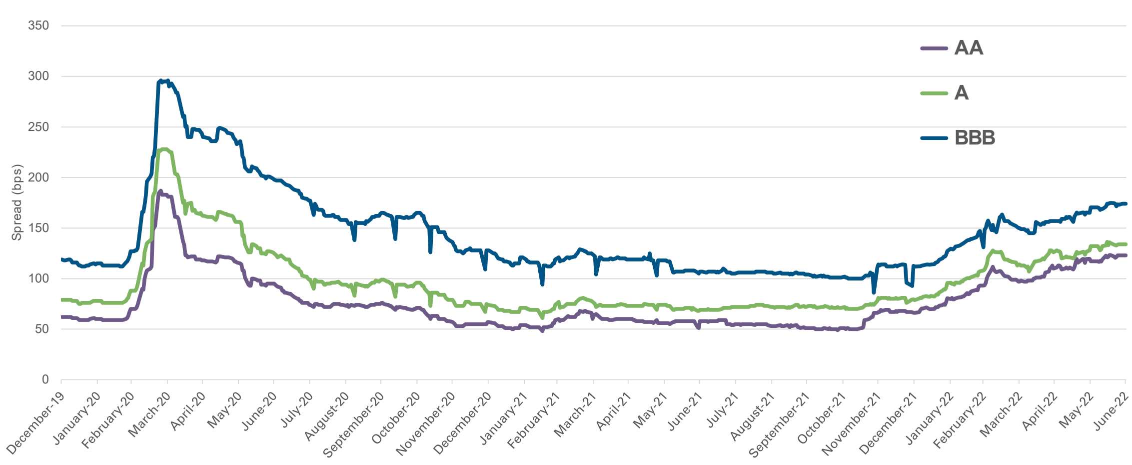
In the early days of the second quarter, Canadian inflation data continued to pick up steam, with CPI YoY exceeding expectations in February and again in March. Following a period with much talk but little in terms of concrete action, the Bank of Canada hiked its overnight rate by 50 bps, to 1.00%, on April 14th. This was the largest increase in twenty years, and essentially an admission that conditions had been left too loose for far too long.

In the ensuing weeks, inflation data continued to worsen, culminating with an expected / well-telegraphed rate hike of 50 bps on June 1st, to 1.50%. With inflation running at multi-decade highs, the statement noted: "the Governing Council is prepared to act more forcefully if needed". This suggests a 75-bp hike is now on the table at the next meeting on July 13th, potentially mirroring the US move, and equally importantly perhaps, a more compressed pattern of hikes culminating with a higher terminal rate.

The Canada Mortgage Bond Purchase Program, Provincial Money Market Purchase Program, BA Purchase Facility, the Insured Mortgage Purchase Program (conducted via CMHC), the Provincial Bond Purchase Program, the Corporate Bond Purchase Program and the Commercial Paper Purchase Program were all discontinued as of mid-April. Effective the week of April 25th, the reinvestment phase ended and the BoC will no longer purchase any Government of Canada bonds, in primary or secondary markets. This was another lever the BoC applied in its efforts to tighten money supply and financial conditions.

Corporate spreads widened in the quarter, driven by interest rate volatility. AA spreads increased 26 bps (to 123bps), A spreads 20 bps (to 134bps), and BBB spreads 24 bps (to 174bps).

5-Year Corporate Bond Spreads



Source: BMO Capital Markets

US Update

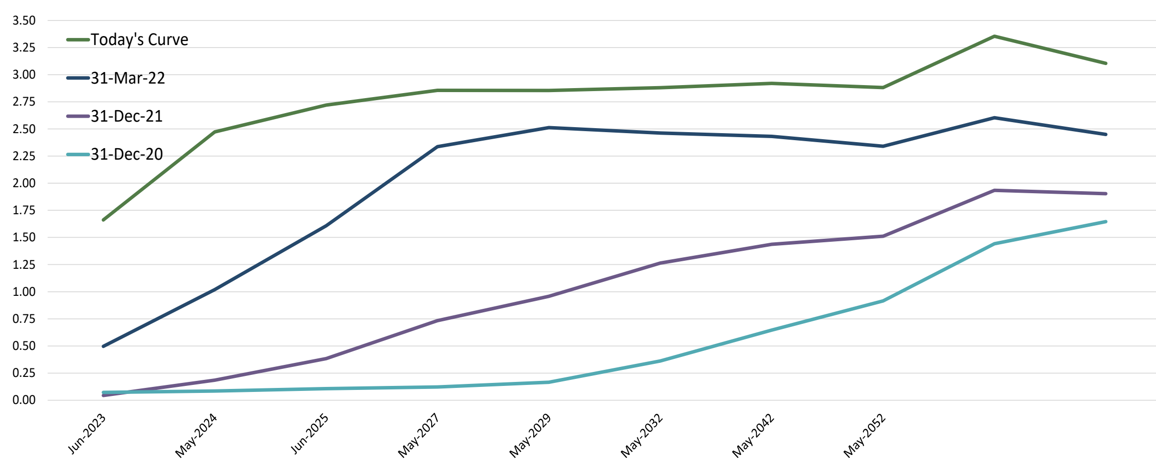
In mid-April, U.S. headline CPI (in)famously hit a 40-year high 8.5% year-over-year pace, and producer prices bested that with a blistering 11.2% year-over-year clip. Still, at the time, some observers saw a 6.5% year-over-year increase for core CPI as a reason for optimism that perhaps fears were a little overblown and that the Fed may not necessarily act as forcefully.

However, ensuing economic data did not support this optimism, reaching its nadir on June 10, as the CPI reading for May exceeded expectations by a wide margin. On June 15th, the FOMC delivered a 75 bps hike, bringing the target range to 1.50-1.75%, the largest hike since 1994. Within the details of the statement, the biggest highlight was the introduction of the phrase "The Committee is strongly committed to returning inflation to its 2 percent objective", signaling perhaps the intent to bring down inflation at all costs, including full employment. Within the Fed's Summary of Economic Expectations, the median 2022 dot* increased to 3.375% (from 2.75%) with the 2023 dot* climbing to 3.75% (from 2.75%), implying the bulk of this tightening cycle occurs this year. In addition, the 2024 dot* is 3.375%, indicating rate cuts may be a reality within two years. The long run dot* was bumped to 2.5% from 2.375%, which might imply a recognition that inflation expectations for the long run may be slightly higher than previously thought. Finally, real GDP estimates for 2022 were lowered to 1.7% from 2.8%, reflecting the impact of the anticipated tightening, opening the possibility the economy is at risk of slipping into a recession as the Fed aggressively hikes.

Quarter in Review

As mentioned above, the Fed hiked 75 bps on June 10th, which followed the 50 bps hike on May 4th. US Treasury yields moved +51 bps to +147 bps, and the front end maturities moved the most due to fears of further and more aggressive Fed interest rate increases. The movement in the US 10-year Treasury yield was 49% peak-to-trough, which is high, but lower than last quarter's 63% peak to trough. The US 3-month Treasury yield was 259% peak-to-trough. Please see the chart below.

US Yield Curve

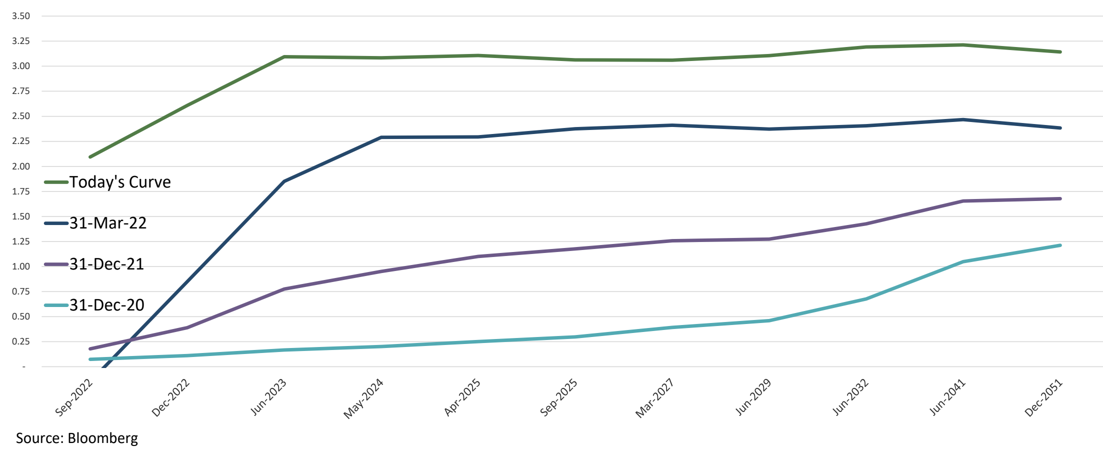


Source: Bloomberg

*each dot represents all 18 individual Fed officials' projection for the central bank's key short-term interest rate, the federal funds target rate, for the next couple of years)

The Bank of Canada instituted a 50 bps hike on June 1st. This followed a 50 bps hike in April. The Canadian yield curve shifted higher and flattened for the quarter as shown in the chart below. Interest rates moved +74 bps to +178 bps with the front-end maturities reacting the most due to the anticipation of further hikes. The movement in the bellwether Canada 10-year bond yield was 51% peak to trough, vs. 78% in Q1/22. Both figures are elevated from an historical perspective. The bigger mover was the 12-month yield, which increased 64% from peak to trough, vs. 139% last quarter.

Canadian Yield Curve



Source: Bloomberg

Interest rate volatility and wider spreads (see Corporate Credit spreads Chart below), impacted returns for all fixed income asset classes (see table below) and made for a challenging environment. The returns were similar in magnitude and direction to those in Q1/22. Together, these two quarters generated the lowest 1st half performance in the FTSE Canada Universe Bond Index since the index began (1992). Shorter duration product, such as Corporate bonds, High Yield bonds, fared a little better than the broad market index above as their rate sensitivity is lower.

Returns for Fixed Income Asset Classes

Asset class returns	Q2/22	Q1/22	2021	2020
Bond Universe Index	-6.0%	-6.97%	-2.54%	8.68%
Corporate Bond Index	-5.1%	-6.45%	-1.34%	8.74%
FTSE High Yield Canadian Index	-5.1%	-3.13%	6.18%	6.69%
S&P/TSX Preferred Index	-8.6%	-2.25%	23.75%	6.11%

Source: Bloomberg

Outlook and Strategy

At the time of this writing, interest rate increase fears, while still substantial, are ceding ground to growth fears. Investors are weighing the probability that central banks can engineer price stability while maintaining positive, productive economic growth. That likelihood has weakened in the estimation of many investors over the past quarter. Crude prices hit multi-year highs, and remain a key driver and wildcard of / for inflation. Given the ongoing developments in the conflict in Ukraine, and that no resolution seems likely in the short-term, it is our belief energy prices will continue at or near current levels. Geopolitics continues to present a risk to global economic growth. Notwithstanding these data points, in our view, inflation is close to, if not at, its peak for the near-term, and while it will likely remain elevated and above the central banks' long-term target for the next few quarters, it will begin to recede soon. Early signs of this occurring are evident in real estate, metals, and slowing wage growth (albeit the most recent readings of these remain high). Given rate hikes are highly likely to occur, we continue to favour the purchase of short duration bonds. We are also favouring higher quality (investment grade) bonds in the possible event of recession which now seems more likely. Yields are the most attractive they have been in quite some time, and opportunities are beginning to present themselves. But we will remain patient and vigilant until we get a clearer picture of inflation and the path of future rate hikes, and feel we are well positioned at present.

Thank you for your ongoing support and hoping you have a terrific summer.

Owen Morgan
Portfolio Manager
Cumberland Fixed Income*
July 4, 2022

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