CUMBERLAND
Private Wealth

FIXED INCOME - FIRST QUARTER 2022

Ready? (or Not) …Changes are Coming

Q1 started with Omicron, the COVID-19 variant being front and center: countries around the world re-imposed lockdowns and travel restrictions. Not sure anyone was "ready" for another wave and being under restrictions again, but as the French say … "c'est la vie". While working from home continued for most of us, it was far from boring for bond portfolio managers: it was like watching the greatest bond movie in history unfold.

Scene 1 (the setup) - The movie starts off in January with both central banks in Canada and the US giving forward looking guidance (or rather warning) to the markets that interest rates needed to be higher. While no action was taken at those January meetings to increase their respective overnight interest rates, it put the bond markets on edge. The warning was really to fulfill their promise to provide the market with ample notice of a change in policy even though it was clearly evident higher interest rates were needed – inflation data released in January (for December) were at an all-time 30 year high (+4.8% in Canada and +7% in the US)[1].

Scene 2 (rising action) – On February 2nd, OPEC[2] met and decided to stick to the gradual increase of oil production. WTI Oil prices were around US$88/bbl at the time (up 15% from the beginning of the year at that point). Inflation data for January were then released shortly after for both Canada and the US (+5.1% and +7.5% respectively)[3] and was anticipated to continue to pick up steam as supply chain issues continued around the world. As the oil market participants seemed to be cooperating with one another, it wasn't the case between Russia and Ukraine. Russia invaded Ukraine on February 24th as the world watched with fear of what would come next– bond yields retraced as investors fled to safe havens.

Scene 3 (climax) –The Bank of Canada ("BOC") held its second bank meeting of the quarter on March 2nd. Market onlookers were eagerly awaiting and the BOC did not disappoint by increasing the overnight interest rate by 25bps[4] to 50bps. As the tension intensified between Russia and Ukraine oil prices continued to climb as WTI oil hit a high of US$123.70/bbl on March 8th. The Federal Reserve ("Fed") followed the BOC's at its March 16th meeting and also increased its overnight interest rate (by 25bps from 0%). Both central banks noted that the rate path would be uncertain but have indicated that directionally it needs to continue to be higher. Also, a 50bps move is not out of the question as an outcome of future meetings which makes sense given current inflation (at 30-year highs) and unemployment levels (pretty much back to pre-pandemic levels).

While this movie is still in motion, you'll need to stay tuned for how it ends: will inflation or overnight interest rates stabilize or will the Russian/Ukraine war be resolved and lastly, are these recent variants the transition to the endemic phase of COVID-19?

Notes:
1. Bloomberg: CPI YOY Index and CACPIYOY Index
2. Organization of the Petroleum Exporting Countries
3. Bloomberg: CPI YOY Index and CACPIYOY Index
4. Bps means basis point. 1bps equivalent to 0.01%

Market Indicators

It is to no surprise that it was yet again another quarter of big moves in various markets. Below (Exhibit 1) are some of the market indicators that we are following.

Exhibit 1: Market Indicators

	Dec 31, 2021	Mar 31, 2022	Comments
WTI Crude Oil (USD)	**$75.40/bbl**	**$100.75/bbl**	+34% on the quarter. OPEC increased production to 400,000 bbl/month in it's Feb 2nd meeting and stuck to it's plan for gradual production increases, even though some members have lagged to produce their target. On March 31st, OPEC continued to stick to plan with production of 432,000bbl/month by May. Since Russia's invasion of Ukraine, many countries have banned Russian oil, reducing supply in a already tight market. Oil hit a high of US$123.70, up as much as 64% during the quarter.
S&P 500	**4,766**	**4,530**	Index was down as much as 13% during the quarter, but has recovered and to being down only 5% by quarter end.
S&P/TSX	**21,223**	**21,890**	+3% increase as the index has decent exposure to energy and commodities, both of which performed well
Price of Gold (USD)	**1,825**	**1,937**	+6% for the quarter as gold peaked on March 8th at USD$2,051 as oil prices also peaked that day and inflation data and Russia/Ukraine issues made investors nervous.
Currency (CAD/USD)	**0.7902**	**0.7996**	Relatively flat on the quarter.
10 Year Government of Canada Bond Yield	**1.42%**	**2.40%**	+68% through the quarter with the BOC indicating a need for higher interest rates. The 10-year Government of Canada bond reacted with the rest of the Canadian yield curve.

Source: Bloomberg

US Update – Playing Catch up?

The Fed had its first meeting of the year on January 26th and while they did not increase the overnight interest rate, they gave the market fair warning that interest rates needed to be higher. The Fed did however, reduce their monthly purchases to US$30billion/month beginning February (they had bought US$120billion/month at the start of the pandemic) and phased out by the end of the quarter. True to their warning, the Fed did not disappoint at their second meeting of the year on March 16th, increasing the overnight interest rate by 25bps from 0bps. The Fed also laid out a more aggressive forecast given inflation concerns from supply chain disruptions/the pandemic, and Ukraine war and effects on energy prices. The Fed has a dot plot (forecast) which it releases with its meetings on potential interest rate increases. Market participants should take this dot plot more seriously over the coming months as the majority of the committee members is now looking for at least 6 additional policy rate increases this year. With an astonishing amount of ~$6 trillion of Treasuries and mortgage bonds bought since the start of the pandemic, the Fed will look to start reducing these holdings in the coming months (i.e. actions referred to as tapering).

Canadian Update – Waiting for the Fed to Catch Up?

The BOC has been in a reinvestment phase since November 2021 and as a result, many market participants expected the BOC to increase its overnight interest rate during its January 26th meeting. However, we believe the BOC did not want to lose credibility and gave clearer forward guidance one last time that higher interest rates were needed. Maybe this was a way for the BOC to align itself to be in sync with the Fed? (As the overnight interest rate was already 25bps higher than the Fed's at the end of 2021). Either way, on March 2nd, the BOC did not hold back and announced a 25bps increase to the overnight interest rate. The BOC also noted that rates would be raised in a "deliberate and careful way, being mindful of the impacts and monitoring the effects carefully". This messaging gives the BOC room to mirror the Fed's hikes if necessary and not out-hike the Fed (which could have other consequences to Canada). Guidance was also provided on quantitative tightening that the BOC would not sell bonds but will just stop replacing maturities (note that 40% of its bond holdings mature within 2 years).

Elsewhere Around the World

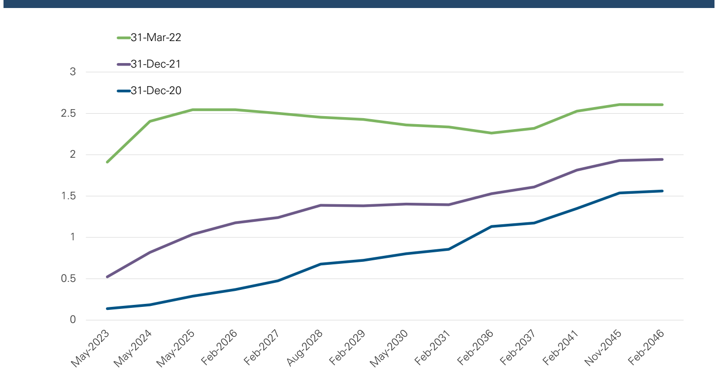
Bank of England, being the first major central bank to increase interest rates last quarter, increased the overnight interest rate another 50bps in the quarter (by way of two 25bps hikes) to 0.75%.

The European Central Bank ("ECB") had entered the pandemic with negative overnight interest rate of -0.50%. Their solution to combat the pandemic was to ramp up quantitative easing, a program that existed prior to COVID-19. As a result, the winding down or reduction of this program will not be as simple as it may be in Canada or the US. During the quarter, the ECB laid out a more formal timeline of how it will phase out of quantitative easing. ECB President Christine Lagarde stated on March 17th that the ECB was in no hurry to raise interest rates and any such move would be gradual. While Europe is also combatting inflation like the rest of the world (hitting 5.9% in the 19-nation euro zone in February), getting back to a positive overnight interest rate will not be rushed and is unlikely to be a 2022 event.

Quarter in Review

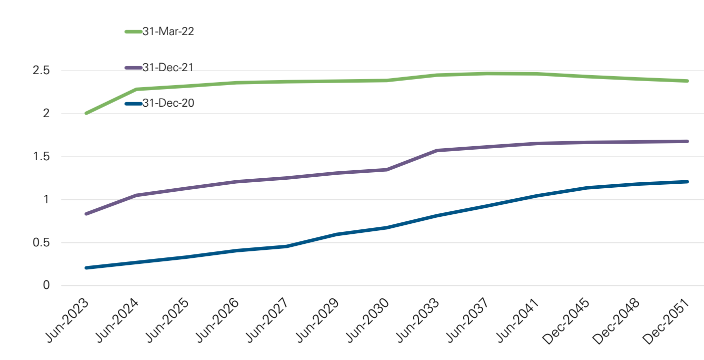
The Fed increased its overnight interest rate to 0.25% (lower bound). US Treasury bond yields moved +66bps to +159bps with the front-end maturities reacting the most due to the anticipation of more increases coming than originally anticipated. The movement in the US 10-year Treasury yield was 63% peak to trough, vs. 26% peak to trough in Q4/21. The bigger mover was the US 2-year Treasury yield, moving 223% from peak to trough with a move of 163bps (up from 184% in Q4/21). Please see Exhibit 2 below.

Exhibit 2: US Yield Curve



Source: Bloomberg

Exhibit 3: Canadian Yield Curve

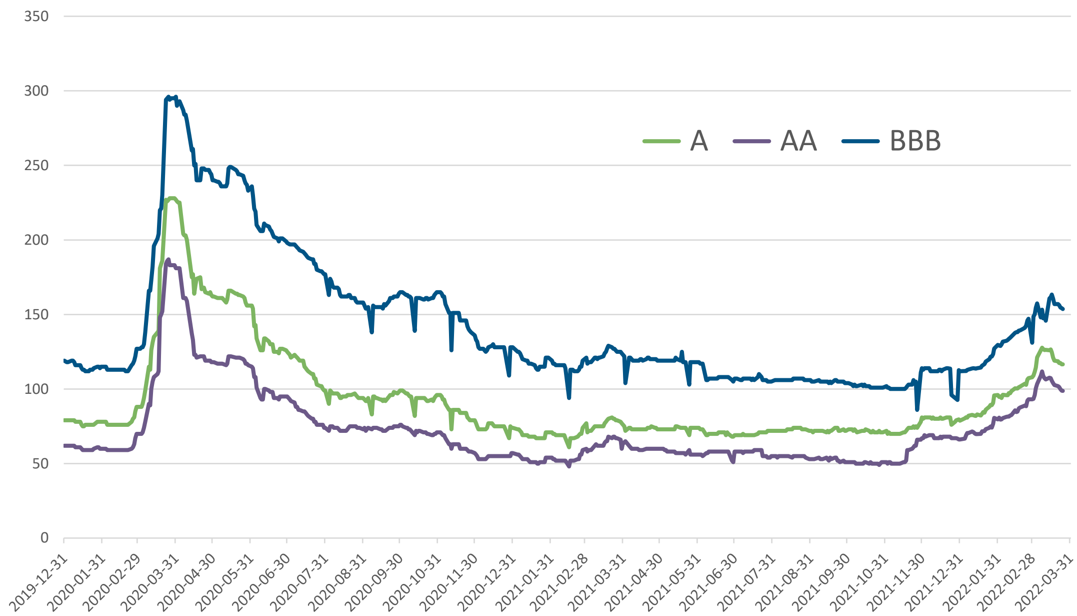


Source: Bloomberg

The Bank of Canada increased it overnight rate by 25bps to 0.50%. The Canadian yield curve shifted higher and flatter for the quarter as shown in Exhibit 3 above. Interest rates moved anywhere between +70bps to +123bps, with the short-end moving the most. The yield volatility of the 10-year Government of Canada bond yield was high at 79% from peak to trough vs. last quarter at 37%. Similar to the US, the 2-year Government of Canada bond yield moved aggressively at 148% from peak to trough vs. 105% last quarter.

New investment grade corporate issuance continued to be strong in the quarter in Canada at $46.5 billion vs. $33.3 billion in Q1/21. We continue to see corporate issuers refinance bonds early or lock-in rates prior to further interest rate hikes by the BOC. 5-year credit spreads widened very quickly during the beginning of the pandemic in March 2020 (see Exhibit 4 below), but narrowed by as much as 200bps since peaking; however, during the quarter spreads did widen out +17bps to +38bps, with 5-year BBB bonds widening the most.

Exhibit 4: 5-Year Investment Grade Corporate Spreads



Source: BMO Capital Markets

Exhibit 5: Returns for Fixed Income Asset Classes				
Asset class returns	**Q1/22**	**Q1/21**	**2021**	**2020**
Bond Universe Index	-6.97%	-5.04%	-2.54%	8.68%
Corporate Bond Index	-6.45%	-3.50%	-1.34%	8.74%
FTSE High Yield Canadian Index	-3.13%	2.22%	6.18%	6.69%
S&P/TSX Preferred Index	-2.25%	12.12%	23.75%	6.11%

Source: Bloomberg

Outlook & Strategy

Ready or not, changes are coming…

We closed Q1 with COVID-19 still around, though milder than the virus was two years ago, we cannot seem to be rid of it totally. Most companies are asking their employees to return to office starting April 4th. Changing times for sure - we will all need to adjust to this change. We also saw inflation continue to climb this quarter to levels not seen in the last 30 years – which we expect will persist for longer than central banks had thought. Russia/Ukraine issues are still ongoing after 34 days since Russia's invasion of Ukraine on February 24th- there will definitely be changes on a global platform (if not already), whatever the outcome will be from this. Central banks are on the move to keep increasing overnight interest rates and likely will only back down when they feel they have reached a point where their respective economies can absorb the increases without slowing them down.

The number of bonds trading above par in the Canadian Investment Grade Bond Universe was ~45% at the end of Q1, far lower than the 85% at the end of Q4. The Canadian Bond Universe Index now yields 3.01% vs. 1.91% (at the end of Q4). Bonds are looking attractive but with additional interest rate increases coming, a slow approach to increase duration is prudent. In the meantime, there are attractive opportunities in the short end to lock in decent all-in-yields, but still save some dry powder.

All the best,
Diane Pang

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April 1, 2022

*Cumberland Private Wealth refers to Cumberland Private Wealth Management Inc. (CPWM) and Cumberland Investment Counsel Inc. (CIC). Diane Pang (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.