Market Overview

North American bond yields were much higher over the last three months (especially longer-term bonds) as the curve steepened on the theme of higher-for-longer interest rates.

Positive economic surprises at the start of the quarter and signs of an easing of inflationary pressures gave investors hope that the U.S. Federal Reserve (Fed) may achieve price stability without tipping the economy into a recession. Meanwhile, the Bank of Canada (BoC) increased rates by 25 basis points (bps) in July to 5% as economic growth had been stronger than expected led by consumer spending. Housing was improving, the labour market remained resilient, and immigration was helping to stimulate the economy. Inflation had fallen but remained more persistent than expected. In August, Canadian data was mixed with headline inflation higher but with growth and employment lower. Investors priced in a 60% probability of another rate hike by December.

In September, rates moved materially higher as both headline and core inflation came in much hotter than expected. Markets moved immediately to price in a full 25 bps increase by the (BoC) by year-end and removed rate cuts built in for 2024. The economy slowed down in Q3, but not fast enough to bring inflation to the 2% target. Population growth, employment and pent-up demand have prevented the economy from going into a recession. The job market had been showing signs of cooling after a blistering start to the year, however, the latest report surprised the upside. The unemployment rate remains low at 5.5% and hourly wages are high at 5.2%. Key measures of core inflation are elevated at 4%. In the U.S. the economy is not slowing very quickly driven by consumer savings, pent-up demand, and a powerful fiscal stimulus. The Fed has hinted they may still need to increase rates again in this cycle but then it will be necessary to hold rates high for a long period to bring inflation down to 2%. The repricing of rate cuts drove bond yields higher and steepened the curve.

Mid-term Provincial spreads were unchanged at 64 bps, but corporate spreads performed well in this environment as spreads narrowed by 5 bps to 182 bps.

Quarter in Review

Duration was positive as we were set up for higher yields, but curve positioning hurt performance as we were expecting a flatter curve. Spread management and carry were also contributors to the performance.

Our sector allocation to Financials and Real Estate were all positive contributors to corporate performance. Security selection detracted from performance and came from our positioning within the Infrastructure and Communications.

The portfolio met its ESG objectives and maintained an ESG score above the benchmark throughout the quarter.

Our weighted duration deviation (WDD) on corporate bonds decreased from -0.12 to -0.30 years as we took profits on spreads narrowing in front of an economic slowdown. We sold across the curve on names that had performed well. The primary corporate market was very active, but we only participated in a few select issuers, which included CIBC, Choice REIT, National Rogers Communications, Coast Capital, and West Edmonton Mall.

Recent ESG Developments

During Q3 2023, we met with the owner and operator of several enclosed mall properties in North America. During our due diligence review, we raised concerns about a lack of disclosure on key environmental and governance factors that were critical to our review. When meeting with management, we expressed our concerns and were advised that the company had made significant progress on reducing its environmental footprint (for example, working with the City/Province to install solar panels as a source of electricity for tenants within the property).
We typically expect sizable issuers in Canada to have clear, well-defined, and ambitious goals/targets that contribute to Canada’s leadership position when it comes to ESG and sustainability. Knowing that the issuer had a strong story to tell, we offered to collaborate and offer guidance on frameworks and tools that can be used to enhance ESG disclosures cost-effectively. We believe that by enhancing its level of ESG disclosures the issuer can not only participate in a better and more transparent Canadian fixed-income market, but also increase its attractiveness to fixed-income investors, both locally and internationally.

**Outlook and Positioning**

We were surprised by the uptick in the core measures of inflation in September after trending lower for most of the year. If this is repeated with the next reading, the BoC will likely increase rates. This outcome is already reflected in the market. The Fed is also getting close to finishing its tightening campaign.

We believe monetary policy is restrictive and over time the economy will slow and lower inflation. Our base case is for an economic slowdown in 2024 that will eventually lead to interest rate cuts, but this is getting pushed further and further out as inflation remains sticky. Investors are now looking for the first interest rate cut from the Bank at the end of the first quarter of 2025.

Portfolio duration ended September slightly above the benchmark at +0.07 years as we gradually increased the term of the portfolio through the quarter to take advantage of the backup in yields and our forecast of slower economic growth next year. Bond yields are currently at the higher end of our expected ranges and if they continue to increase, we will look to further add duration to the portfolio.

Although corporate spreads generally reflect our base case, we did take profits in the quarter as some names got very expensive on the back of strong investor appetite. If corporate spreads tighten more, we could look to take further profits or if they widen to reflect a significant slowdown, we could increase our exposure. We continue to closely monitor issuers that are more sensitive to higher interest rates factoring in the higher-for-longer backdrop. The yield carry from our overweight in credit has declined to 18 bps from 22 bps.