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 to 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.

In this environment, short-term Provincial spreads decreased by 2 bps to 35 bps and corporate spreads narrowed by 9 bps to 137 bps.

Short-term rated municipal spread performance moved in line with provincials, while non-rated municipals underperformed provincials by approximately 10 bps.

Quarter in Review

The fund’s absolute return was a function of yields increasing and non-rated municipal spread widening, partially offset by carry. The portfolio generated 10bps of carry and 2 bps from duration/curve, however, this was more than offset due to the relative spread widening of non-rated municipal bonds. Non-rated municipal spreads in the five-year term are approximately 90 bps relative to provincials which is, historically, an attractive entry point.

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 +0.09 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.

Corporate spreads (and in turn, non-rated municipal spreads) generally reflect our base case of a modest recession, but if they tighten too quickly, we will look to take profits or if they widen to reflect a significant slowdown, we will increase our exposure. The yield carry from our overweight in non-rated municipals has increased from 39 bps to 44 bps.