Canadian Quarterly Fixed Income Report | Q2 2022

BEUTEL GOODMAN Investment Counsel

June 30, 2022

Market Snapshot

Canadian Rates	Current	Change (Basis Points)		
		Month	QTD	YTD
3 Month T-Bill Yield	2.08%	61	148	192
2 Year Bond Yield	3.10%	43.3	80.5	214.4
5 Year Bond Yield	3.11%	36.6	69.6	185
10 Year Bond Yield	3.22%	33.2	81.8	179.7
30 Year Bond Yield	3.14%	28.9	75.2	145.7

	Current	Change (Basis Points)		
		Month	QTD	YTD
3 Month U.S. T-Bill Yield	1.72%	56	120	166
2 Year U.S. Bond Yield	2.92%	39	64	219
5 Year U.S. Bond Yield	3.01%	20	59	175
10 Year U.S. Bond Yield	2.98%	13	66	146
30 Year U.S. Bond Yield	3.14%	7	70	124

Currencies	Current	Change (%)		
		Month	QTD	YTD
CAD/USD	1.29	2.0%	3.3%	2.1%
EURO/USD	0.96	2.5%	6.4%	8.8%
Trade Weighted USD	104.68	2.9%	6.5%	9.1%

Equity Indices	Current	Change in TR (%)		
	(Price Index)	Month	QTD	YTD
S&P 500	3785	-8.3%	-16.1%	-20.0%
S&P/TSX	18861	-8.7%	-13.2%	-9.9%

Credit Index OAS	Current	Change (Basis Points)		
		Month	QTD	YTD
Investment Grade	156	26.3	41.1	63.5
High Yield	569	163.0	244.0	286.0

Commodities	Current	Change (%)		
		Month	QTD	YTD
WTI Crude Oil (US$/bbl)	$105.76	-7.8%	5.5%	40.6%
WCS Crude Oil (US$/bbl)	$87.60	-9.5%	-2.1%	39.3%
Gold (US$/ounce)	$1,807	-1.7%	-6.7%	-1.2%

Source: Macrobond, Bloomberg (for Credit Index OAS)

Market Commentary

"You cannot just keep borrowing more and more and keep spending more and more without eventually having a day of reckoning" – Wilbur Ross

Volatility has been a recurring theme in markets for some time now, and the second quarter of 2022 proved no exception. In fact, market swings were even more pronounced in the period, and investors found few places to hide as yields rose across the curve, particularly in the short end; spreads widened; and risk assets ranging from cryptocurrencies to credit declined. After more than a decade of shrugging off worry after worry in the face of easy money, markets appeared to have found the straw that broke the camel's back in the form of aggressive central bank interest rate hikes that are attempting to curb high inflation.

As we've noted in past reports, the unprecedented fiscal and monetary policy stimulus provided during the pandemic was a means to bridge economies over the deep economic effects from the imposition of lockdowns. However, while we still believe stimulus was necessary, it has become apparent that central banks and governments alike kept up the medication long past the patient's recovery. By most measures, the U.S. economy, while slowing from post-lockdown peaks, is still growing, with personal consumption growing by 1.8% in Q1/2022 and the unemployment rate hovering at 3.6% in June. In Canada, the unemployment rate has come down a bit more slowly given the longer lockdowns but was still at multi-decade lows of 4.9% in June, a decline from 5.1% in May and 5.2% in April. Canada also recorded annual GDP growth in the first quarter that was above potential, expanding 2.9%.

The strength in these economies, coupled with continued supply-chain issues and strong consumer demand, drove inflation in the U.S. and Canada to 40-year highs of 8.6% and 7.7%, respectively, in May. This goods and services inflation, in turn, has now driven growth in wages, with the U.S. Bureau of Labor Statistics reporting a year-over-year increase in average hourly earnings of 5.1% in June, on the heels of a 5.3% rise in May. In Canada, Statistics Canada reports that average hourly earnings rose 5.6% year over year in June, after an increase of 4.5% in May. However positive wage growth may appear to be, though, the concern now is that we may enter a wage/price spiral, where the growth in wages spurs ever higher inflation as companies pass along higher labour costs to consumers.

Faced with this conundrum, central bankers – who all came of age during the Paul Volcker era – have determined that the recourse is to raise rates, sharply and quickly. The goal, in essence, is to stabilize inflation expectations and prevent a wage/price spiral by tightening financial conditions, reducing consumer confidence, and creating enough economic uncertainty to halt wage growth.

Some leading indicators suggest these rate moves are already working; consumer confidence, as measured by the University of Michigan Consumer Sentiment survey, recorded a low of 50.0 points in June, down from 58.4 in May and 65.2 in April. Canada, according to Ipsos, is moving in lockstep, recording a decrease to 50.4 points in June, from 52.2 in May. On the other hand, other indicators may take more time to reverse course: despite the dip in consumer confidence and some weakness in retail sales, the U.S. actually added 372,000 jobs to non-farm payrolls in June, more than consensus forecasts of 268,000.

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At this point, most market participants – and consumers – would likely agree that interest rate hikes are necessary to curb inflation. And, given the level of telegraphing central banks have done to this point, they have been widely expected. Arguably, it's the aggressiveness of the rate hikes that surprised markets and resulted in the broad increase in volatility. However, in our view, what has scared markets more this time around is the overall level of uncertainty. Central banks seem unsure about how fast inflation will fall, when they're going to stop hiking, and how much above "neutral" we're going to get. More worrisome is that they don't seem to know where the neutral rate is anymore. This lack of confidence from central banks is a lot for markets to process and has led to many investors and economists alike pondering the potential for recession. If central banks don't know what the appropriate terminal rate should be (the level at which they stop hiking), then it will likely be difficult to achieve a soft landing. Perhaps a fitting analogy is one of rushing to an emergency in the middle of the night. You know you have to get to your destination quickly and so you end up driving too fast on dark roads. While you may indeed arrive safely and quickly, you know that speed and limited visibility increase the chances of a crash. This is where central banks have now found themselves, and only time will tell whether they arrive with the economy intact.

Central Bank Watch

The theme that nearly all central banks seemed to agree on this quarter was the need to tighten monetary policy, through rate hikes and other measures, to rein in increasing levels of inflation.

In the U.S., the Federal Reserve (Fed) continued the rate-hiking cycle it began in the first quarter of the year, raising the Federal Funds rate twice in Q2, to the current range of 1.50%-1.75%. The rapid progression from a 25-bps hike in March, to a 50-bps increase on May 4 to an aggressive 75 bps at its June 14-15th meeting has led to significant volatility in the period, with bond markets now pricing in a terminal rate of 3.75%. At the June press conference, Fed Chair Jerome Powell did not rule out further large-scale rate increases in the coming months, essentially telegraphing to markets that the bank will fight inflation at the expense of other areas of the economy.

The Bank of Canada was also busy in the second quarter, following up a 25-bps hike on March 2 with two 50-bps increases on April 13 and June 1, respectively. The bank stated in its June 1 press release that the "economy is clearly operating in excess demand", with elevated job vacancies, widespread labour shortages, robust consumer spending and "exports anticipated to strengthen". However, it also acknowledged that inflation was "persisting well above target and expected to move higher in the near term", and as such, it was "prepared to act more forcefully if needed to meet its commitment to achieve the 2% inflation target".

In its June 9 press release, the European Central Bank (ECB) noted that high inflation has become a major challenge, and ended net asset purchases under its asset purchase programme as of July 1. The ECB added, however, that it will continue to reinvest principal payments from maturing securities for as long as necessary. More concerning to markets, though, was the statement that the bank intended to raise the key ECB interest rates by 25 basis points in July and expected to hike rates again in September, potentially by a larger amount, if inflation persists or goes higher.

The Swiss National Bank surprised markets at its monetary policy meeting on June 16, with a policy rate hike of 50 bps, bringing the key interest rate to -0.25% from -0.75%. All but a small handful of central banks are now opting for significant increases in overnight rates as inflation continues to bite globally. While it might seem that addressing a global problem like inflation calls for unified action, when the world becomes this synchronized, we start to see much larger swings and volatility in asset prices and economic growth. And with most of the world economies tightening, there are bound to be ramifications.

The only major economies not to join the rate-hiking party yet are the Bank of Japan and the People's Bank of China, each of which has a rather unique set of circumstances. Potentially positive news in this is that given China's significant role in the global economy, should it opt to ease, it could offset some of the effects of the synchronicity we're seeing right now.

Sovereign Watch

Sometimes there are unintended consequences that come from a tightening cycle. The world has benefited considerably from globalization over the last few decades (including lower prices on all types of goods and efficient and fluid supply chains, which had kept inflation well below historical levels). However, the logistics that power the global economy are in fact quite fragile, as we discovered

during the pandemic and when Russia invaded Ukraine. This war ended up impacting countries on every continent, with issues ranging from high inflation to food and energy scarcity.

In this type of environment, governments tend to shift to a more nationalistic, “take care of our own population first” way of thinking. However, this fuels inflation issues. For example, when India starts restricting wheat exports, and Brazil halts sugar exports, and China bans fertilizer exports, and so on, supply becomes scarcer and prices continue to rise. Central bank rate hikes can only affect the demand side of the inflation equation, and mainly demand for discretionary items at that; basic necessities like food and energy are much more difficult to control when external factors such as protectionist policies are in play.

However, it is important to note that this is not our base-case scenario. After decades of globalization, we do not believe the U.S. will accept a mass shutdown of trade, particularly when it may lead to a long upward spiral of inflation. In addition, while “made in America” is a central theme in the U.S. today, in our view American companies that bring production home will pass along the large increases in labour and other costs to consumers, driving inflation higher. As a result, we believe the U.S. will be compelled to pause internal squabbles and use its considerable influence on the world stage to manage the process of deglobalization that has been set into motion.

Nonetheless, we do believe the world is headed for some form of deglobalization, with regional alliances likely to fill the void under the concept of “safe supplying”. A global regime change of this magnitude is, in our view, still likely to lead to additional inflationary pressures, as the shift to onshoring, particularly in Western countries but also in the developing world, ultimately comes with significantly higher labour and input costs. As a result, we expect central banks may have to abandon their current target inflation levels of 2% and ease people into a new normal of 3% per year or more. The global regime change will also lead to political and economic instability in some emerging markets such as we are seeing play out currently in Sri Lanka.

Outlook

The events of the past two-plus years have created a perfect storm for inflation. In addition to an uptick in excess savings due to constraints on consumption during COVID lockdowns, a significant level of pent-up demand was unleashed on unprepared businesses once the world started opening back up. This increase in demand was met with insufficient supply due to logistics issues and external shocks such as Russia’s invasion of Ukraine. It could be argued that fiscal policy contributed to the inflation problem as well. While pandemic subsidies and stimulus measures were necessary to carry people through the worst of the lockdowns, they likely lasted longer than they should have, and the overstimulation of the economy contributed to persistently high inflation.

Now, central banks have realized that the persistence of inflation has begun to affect consumer sentiment. And now that the belief that inflation will continue to rise has set in, it has necessitated the need for wage increases to help keep up with rising prices, potentially leading to a dangerous wage/price spiral. Central banks must act quickly to tackle not just inflation itself, but the expectations that elevated levels of inflation are here to stay. We believe this is the main reason for the Fed’s aggressive 75 bps move, and the warning that more could follow. In our view, the Fed, along with the Bank of Canada, the ECB, the Bank of England, and other central banks, need to convince consumers – and markets – that they will prioritize the fight against inflation above all else, including jobs and economic growth. The central banks can’t directly affect food or energy prices, or supply issues caused by supply-chain disruptions or war in Ukraine, but in our view, they need to seek to slow, as much as possible, consumer discretionary spending.

Going forward, such central bank actions will, most likely, lead to lower inflation. However, slowing demand down could also potentially lead to a recession. So far, we haven’t seen significant changes in the leading indicators – such as a decline in job creation or a steep rise in jobless claims – that would lead us to believe the current level of interest rates is significantly affecting the economy. However, central banks tend to drive by looking in the rear-view mirror; that is, they rely on lagging indicators to make monetary policy decisions. This is an important detail, as it means they will likely continue to tighten until they see a change in those data points – not when there’s a change in the leading indicators. Thus, we believe the chances of them overtightening and potentially “breaking” something are high.

A recession, at some point, is inevitable. Central banks, and markets, are waking up to the reality that you can’t inject endless amounts of cash into the system, maintain interest rates at the zero bound, and let demand continue unconstrained in an environment of limited supply, and expect everything to work out. For the last decade-plus, there’s been no consequence to easy monetary and fiscal policy; but

at some point, there's always a reckoning. We may now be at that point with inflation, and central banks have no choice but to fight it no matter what the cost to the economy.

The good news is that this comes at a time when the consumer is in relatively good shape, with savings rates relatively high and unemployment at multi-decade lows. In the event of a recession, we can likely weather the storm. Whether people actually see it that way, when they watch household wealth begin to erode as housing prices and other assets correct, though, remains to be seen.

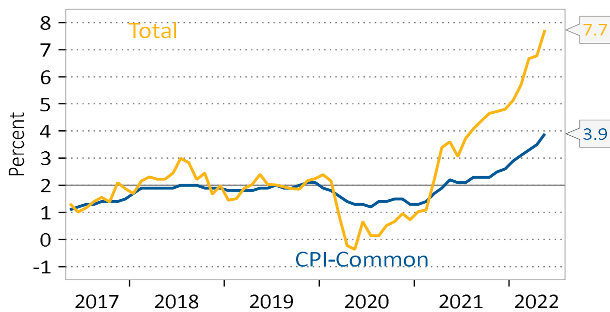
Positioning

We believe a lot of the risks in bond markets are priced in and that yield curves will continue to flatten until central banks reach a peak in the hiking cycle. Our portfolio is thus currently neutral to fractionally long duration relative to the benchmark and we currently expect to maintain this positioning until: (1) leading economic activity indicators such as job growth, initial jobless claims and PMIs continue to reflect the softness in the economy we've seen recently; and (2) inflation starts to roll over. When these factors occur, we expect to move toward a long duration positioning.

The backdrop for credit remains marginally positive given the continued strength in the economy; however, we have seen credit spreads widen and expect they will widen further as the case for recession builds steam. In this scenario, many companies will come under stress and we are likely to see the beginning of a new default cycle. Rising defaults will have impacts on credit supply, which we already expect to slow into the rest of the year now that most companies have already raised funds ahead of rate hikes. That said, we still see pockets of value that create opportunities, and thus for now are maintaining an overweight to corporates, but are focused on defensive, safe-haven, short-duration credit.

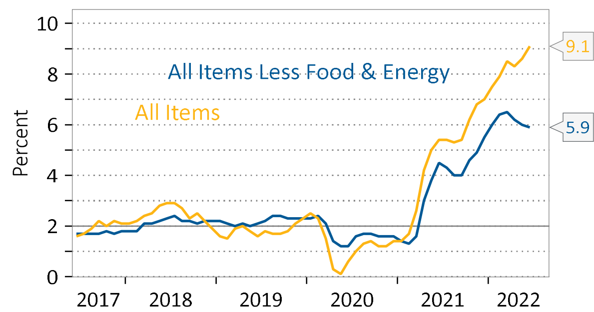
Macro Economic Charts (As at June 30, 2022)

Canada CPI, YoY



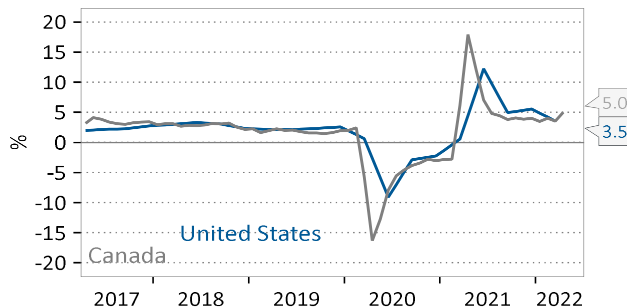
Source: StatCan, BLS, BEA

US CPI, YoY



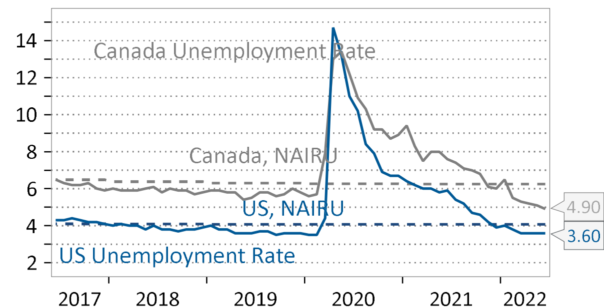
Source: StatCan, BLS, BEA

Real GDP, SA, YoY



Source: StatCan, BLS, BEA

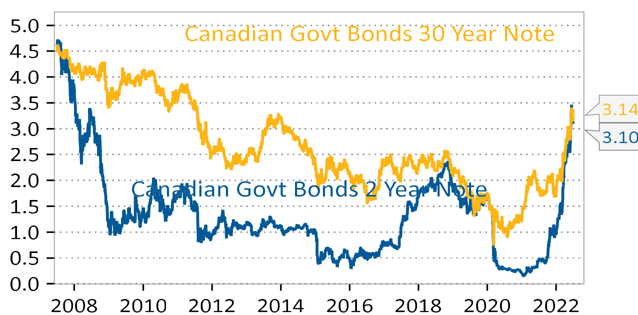
Unemployment Rate, SA



Source: StatCan, BLS, BEA

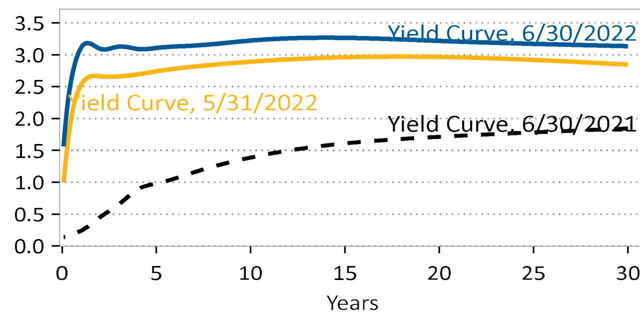
Rates Charts (As at June 30, 2022)

Benchmark Canada Yields



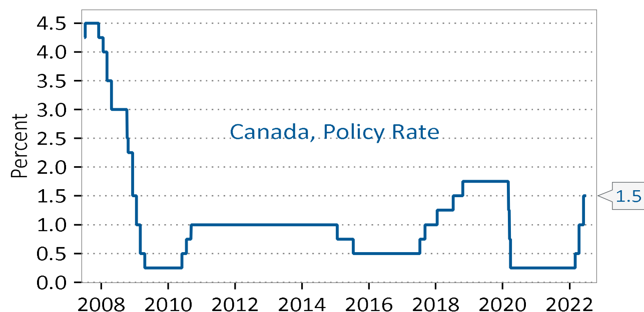
Source: BoC

Canada Yield Curves



Source: BoC

Bank of Canada Overnight Rate



Source: BoC

Sovereign Yields

Country	Overnight Rate	2 Year	10 Year
Canada	1.50%	3.11%	3.21%
United States	1.75%	2.92%	2.98%
United Kingdom	1.25%	2.22%	2.26%
Germany	-0.50%	0.57%	1.44%
Italy	-0.50%	1.44%	3.31%
Spain	-0.50%	0.98%	2.55%
Japan	-0.10%	-0.05%	0.22%

Source: Macrobond

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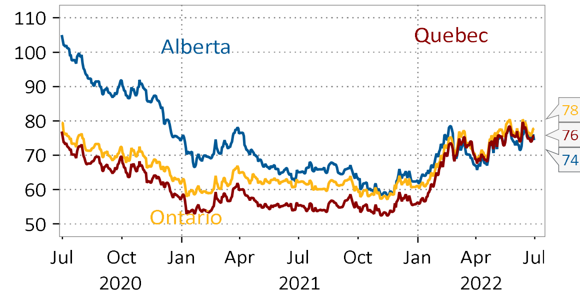
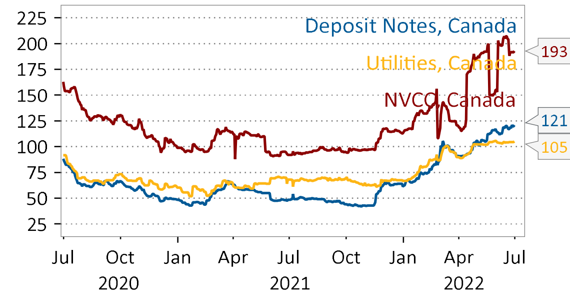
Credit Charts (As at June 30, 2022)

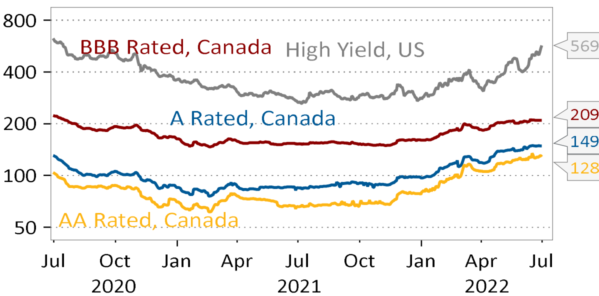
Provincial Spreads, 10 Year



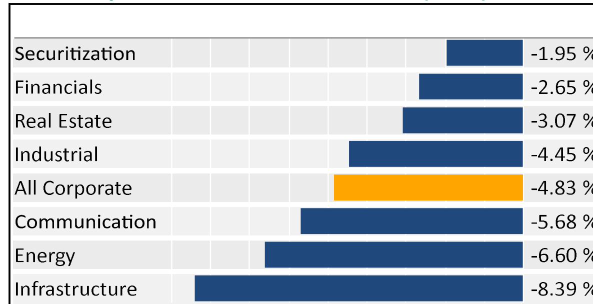
Corporate Credit Spreads



Corporate Spreads by Rating

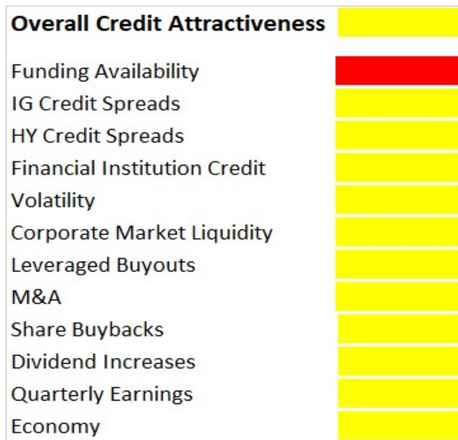


FTSE Corporate Sectors Total Return (QoQ)

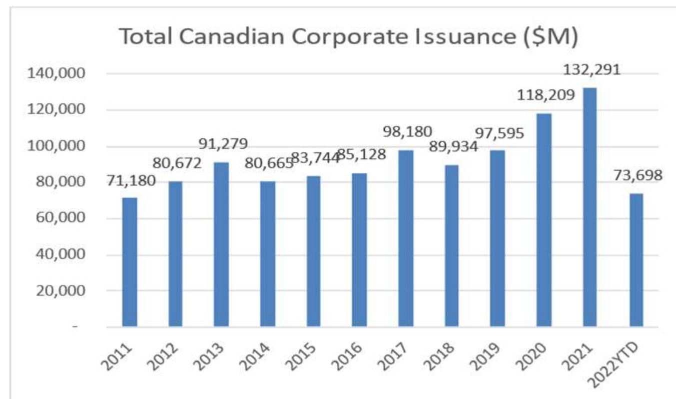


Source: FTSE Global Debt Capital Markets Inc.

Corporate Event Risk Monitor



New Corporate Issues in the Canadian Market

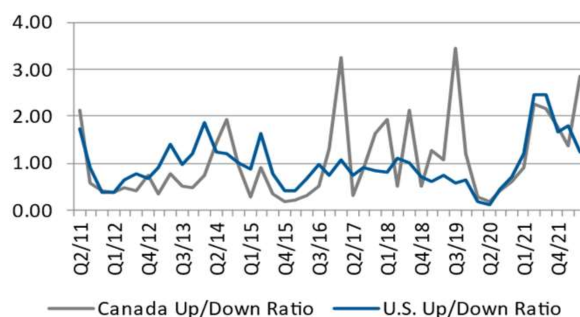


As of June 30, 2022 *Source: Beutel Goodman*

Canadian Mergers & Acquisitions

As of June 30, 2022 *Source: Bloomberg*

Credit Rating Upgrade/Downgrade Ratio

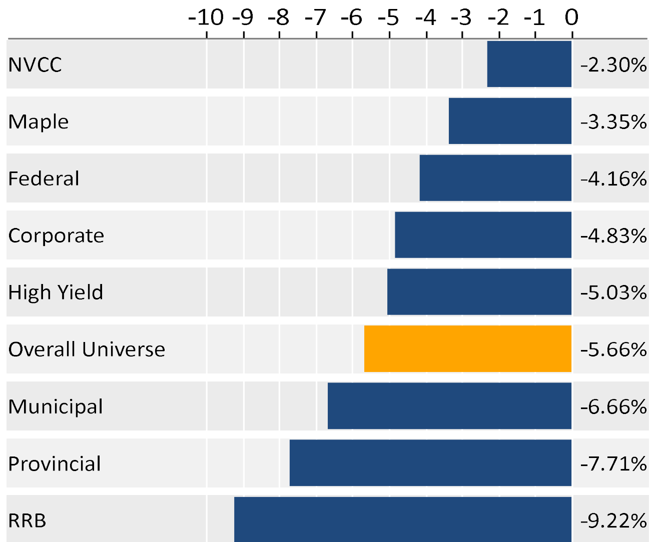


As of June 30, 2022 *Source: Bloomberg*

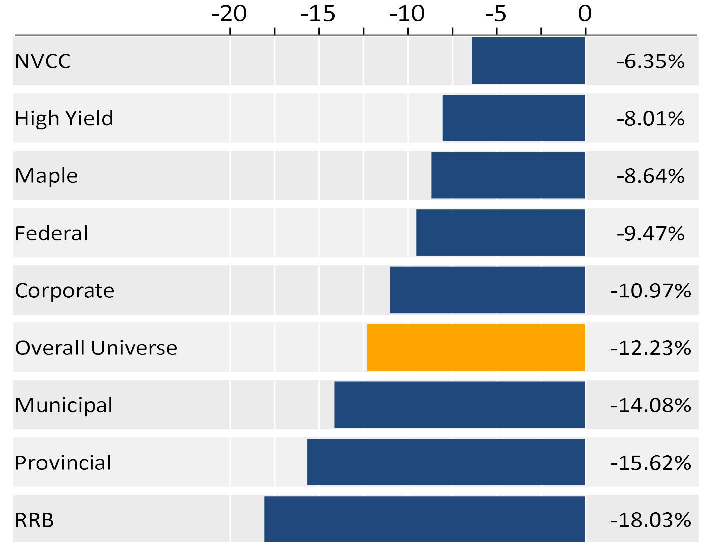
Index Returns

FTSE Canada Universe Bond Index

QoQ Return

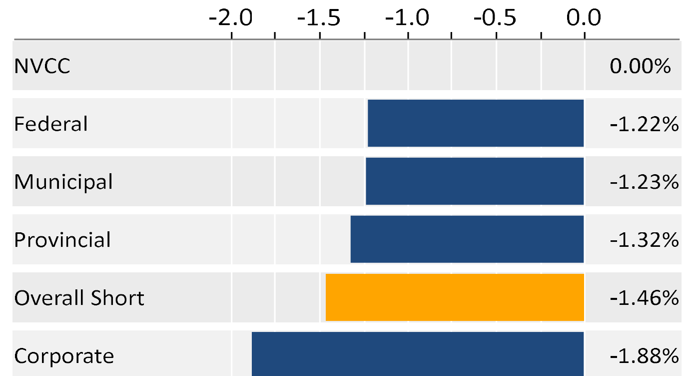


YTD Return

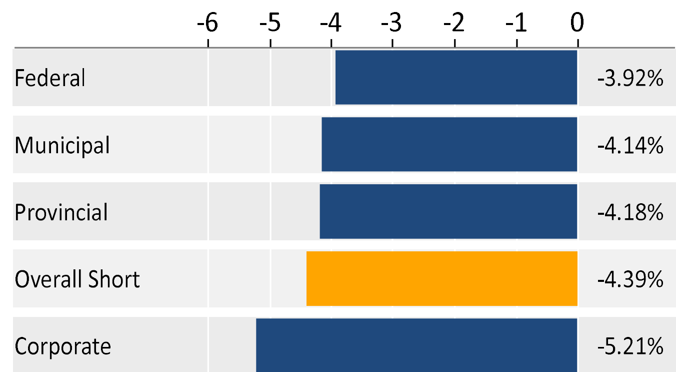


FTSE Canada Short Term Bond Index

QoQ Return

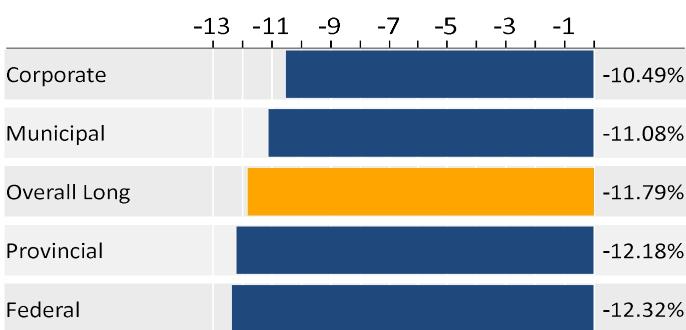


YTD Return

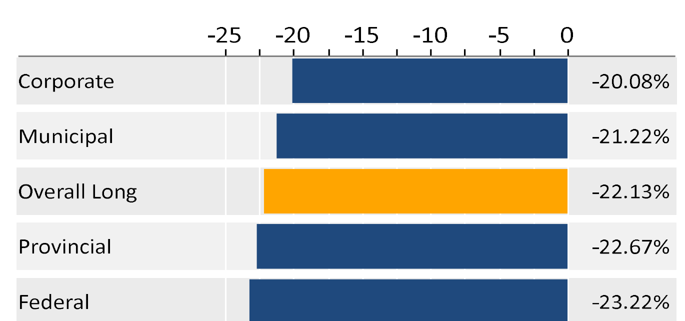


FTSE Canada Long Term Bond Index

QoQ Return



YTD Return



Source: FTSE Global Debt Capital Markets Inc.

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