Empire Life Fixed Income Update
A Year-to-Date Recap of the Bond Market

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The Government Bond Market

We started the year off with a bang as fixed income markets rallied and began pricing in an interest rate cutting cycle in January for the rest of the year, which seemed premature. The Bank of Canada also paused their rate hiking cycle in January, which only added to the notion that rate cutting was in the cards for the second half of the year.

Fixed income markets retreated (i.e. rates moved higher) in February in both Canada and the U.S. in response to persistently strong economic data, particularly in retail sales and in the labour market. In March, we saw heavy headlines in the banking sector with the U.S. regional bank crisis, led by the collapse of Silicon Valley Bank and followed by the potential collapse of Credit Suisse. Both events contributed to "a risk-off" sentiment and fears of contagion, with bonds rallying as a result.

The market began pricing in rate cuts again for the remainder of 2023 as market participants began speculating that the crisis would be widespread. However, the U.S. Federal Reserve set up new liquidity facilities and temporarily guaranteed deposits to shore up confidence in the banking system, while Swiss regulators provided significant support to UBS to acquire Credit Suisse.[1]

Following these events, calmer conditions prevailed, but economic data continued to surprise to the upside in both Canada and the U.S., showing the resilience of the consumer, the labour market, and inflation. In Canada, reported retail sales were stronger than the consensus expectations in four out of the six reports since the Bank of Canada paused rate hikes, while reported employment figures were higher in six of the last eight reports over the same period. In the U.S., retail sales have also held in, with four of the eight reports released since January coming in ahead of expectations. Employment also followed suit, coming in higher than expected for five of the last eight reports over the same period.

Inflation has trended lower throughout the year, particularly in previously problematic areas like used cars and airline flights. However, inflation remains stubbornly above the 2% inflation targets[2]. In Canada, both the headline and core inflation measures continue to remain relatively elevated (i.e. higher than the 2% target) and appears to have reaccelerated in recent months. In the U.S., inflation has been surprising to the downside and has been coming in below expectations while remaining higher than the 2% target. Survey-based measures of inflation expectations also remain elevated in both Canada and the U.S. but have been trending lower recently.

[1] Swiss government support included: the full write-down of Credit Suisse AT1 subordinated debt; guarantees on any potential losses of certain assets; additional liquidity

[2] Source: U.S. Bureau of Labor Statistics, Statistics Canada, Bloomberg as of August 31, 2023.

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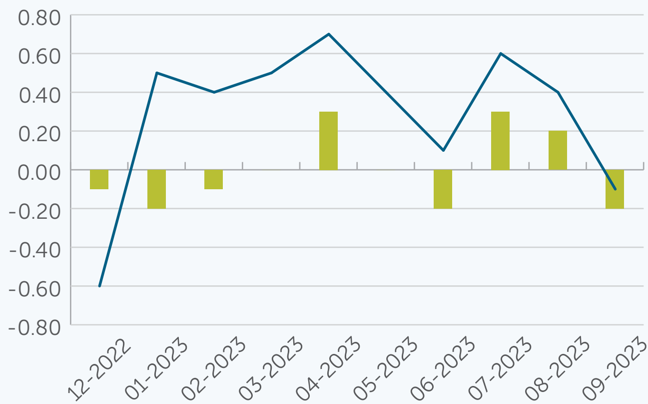
YTD Inflation vs. Analyst Expectations

Canadian Inflation MoM vs Expectations

Canadian Headline CPI, M/M and vs Consensus

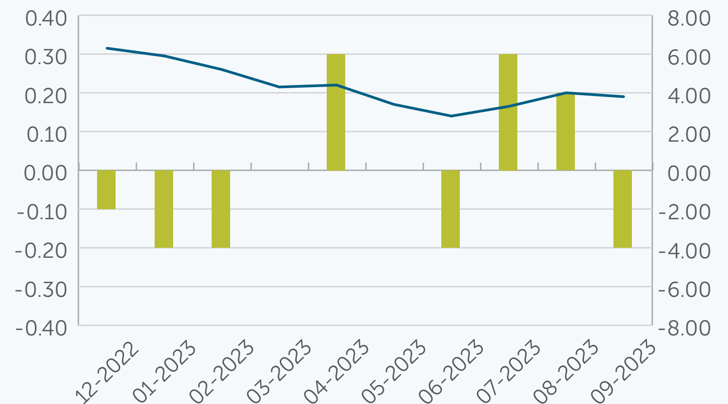


Canadian Headline CPI, M/M vs Consensus

Canadian Headline CPI, M/M

Canadian Inflation YoY vs Expectations

Canadian Headline CPI, Y/Y and vs Consensus

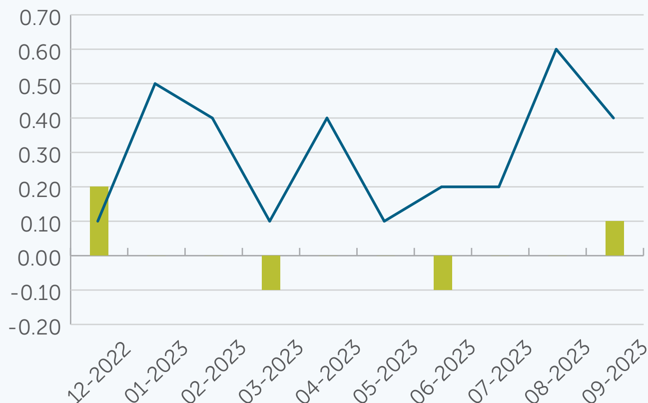


Canadian CPI, Y/Y vs Consensus (RHS)

Canadian CPI, Y/Y (LHS)

US Inflation MoM vs Expectations

US Headline CPI, M/M and vs Consensus

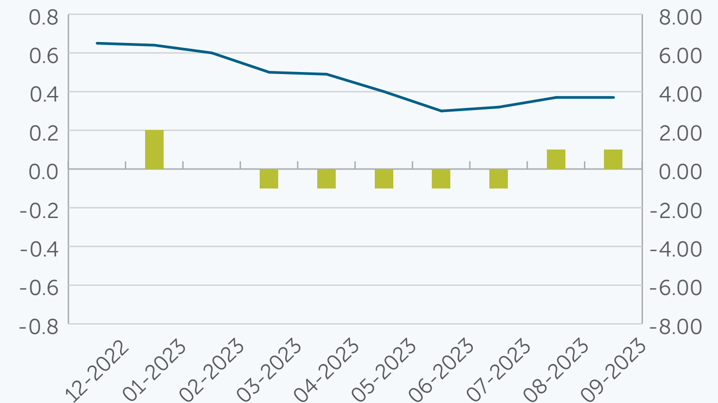


US CPI, M/M vs Consensus

US CPI, M/M

US Inflation YoY vs Expectations

US Headline CPI, Y/Y and vs Consensus



US CPI, Y/Y vs Consensus (RHS)

US CPI, Y/Y (LHS)

Source: Bloomberg, as of September 30, 2023. RHS stands for Right Hand Side, LHS stands for Left Hand Side.

Warning signs have not waned

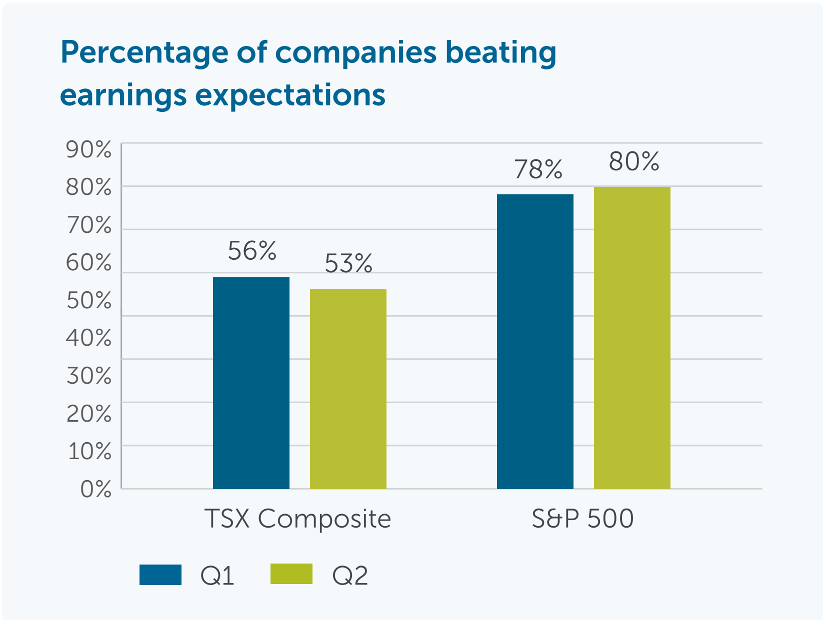
What was particularly troubling in Canada was the observed reacceleration in housing market activity, with real estate prices continuing to move higher, as the “pause” by the Bank of Canada was interpreted as a sign that the hiking cycle was complete.

The strength in both consumer spending and employment led to further tightening from central banks, notably in Canada, where the Bank of Canada resumed its hiking program after a series of positive data points, hiking the overnight rate by 25 basis points in both June and July. This approach differed from that of the Fed, where we saw 25 basis points hikes at every meeting before a brief pause in June, which was then followed by another 25 basis point increase in the July meeting.

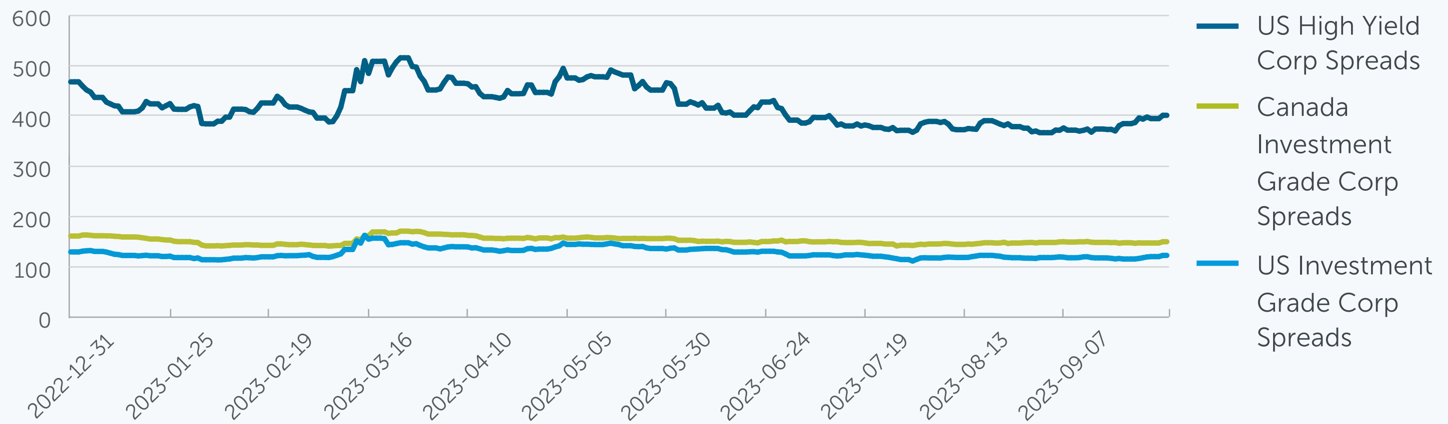
We've also had some negative headlines for fixed income emerge during the year. We have seen greater supply dynamics in the U.S. and Canada as debt issuance increased in both countries, which should put some upward pressure on yields. The Bank of Japan also announced that they were re-evaluating their interest rate policy and adjusting their yield target higher for Japanese 10-year bonds. This may weigh on yields as Japanese buyers purchase more domestic bonds instead of international bonds.

The Corporate Bond Market

Corporate spreads (the yield pick-up compared to a government bond with the same maturity) in both Canada and the U.S. peaked this year in March. This was due to fears that the U.S. regional banking crisis and collapse of Credit Suisse could spill into other parts of financial markets and/or the real economy. As these issues proved to be contained, relatively strong economic data continued for the majority of Q1 and Q2 with corporate earnings exceeding expectations and credit spreads tightening to new lows for the year.



Source: Bloomberg, as of August 31, 2023



Source: Bloomberg, as of September 30, 2023

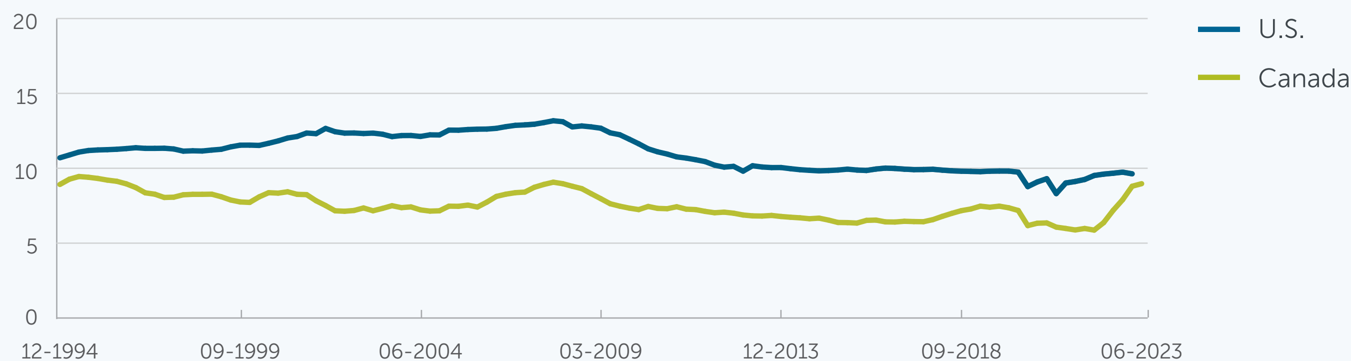
WHERE DOES THIS LEAVE US?

Government bonds offer attractive yields with little to no credit risk

As we enter the fall, data dependency continues to be the preferred approach of central banks as they continue to monitor the lagged effects of monetary policy. After having tightened monetary policy rapidly in 2022 and 2023, central banks in Canada and the U.S. are carefully watching incoming economic data and will respond accordingly. If economic data continues to soften, central banks may refrain from raising interest rates further while keeping monetary policy restrictive. Both central banks left overnight rates unchanged in their most recent meetings, but the door is open for further increases in interest rates if incoming data continues to be strong.

However, we see differences between the Canadian and U.S. economies. With Canada's economy having strong ties to real estate and housing, it remains highly interest rate sensitive given debt levels. In contrast, the U.S. economy is less reliant on one large sector, and the U.S. consumer is less sensitive to interest rates due to lower debt levels. As such, Canada and the U.S. should differ somewhat in their reactions to tighter policy. As seen below, the Canadian debt service ratio has spiked dramatically from the COVID lows, while the U.S. debt service ratio has increased but rolled over somewhat.

Debt Service Ratio: Canada vs U.S.



Source: Bloomberg, as of August 31, 2023

The U.S. economy has remained surprisingly robust despite tighter monetary policy and positive real rates. Employment, consumer spending, and the housing market have all held up well despite the restrictive state of monetary policy. The strength of the U.S. economy has been somewhat perplexing in the face of various measures showing some weakness. For example, indices of regional activity and the purchasing manager indices are showing negative values or are near levels consistent with past recessions. However, corporate earnings and employment continue to hold up for now.

Similarly, the Canadian economy has remained quite resilient in the face of positive real rates. Employment has remained relatively strong, while corporate earnings are in decent shape. We are seeing housing activity begin to slow both in terms of volumes and prices as the most recent interest rate hikes from the Bank of Canada continue to weigh on the sector. The data is beginning to show some early signs of slowing in the economy. Retail sales have lost momentum and were negative in four of the last six months on a volume basis. Labour trends continue to remain resilient for now, but in the face of slowing economic growth, companies tend to protect margins by reducing expenses across the business, including the labour force.

Central banks are likely to maintain restrictive policies for the time being, keeping rates higher for longer. Interest rate futures in the U.S. are pricing modest cuts into 2024, while Canadian interest rate futures are pricing the potential for another further hike in 2024, followed by some slight easing near the end of the year. This is consistent with the idea that monetary policy will remain restrictive. Real rates are defined as nominal interest rates less the inflation rate. If central banks hold nominal rates at their current levels, and inflation is naturally declining from higher levels seen a year ago, all else equal, real rates should increase and further increase the restrictiveness of policy. However, if inflation continues to surprise to the upside, we may see nominal rates rise further in order to keep policy restrictive. If policy is deemed to be adequately restrictive, it stands to reason that some cuts may be imminent in the future but are unlikely to return to the proximity of the zero lower bound. Government bonds would benefit from any cuts in interest rates, and if the economy continues to weaken, it is possible that we may see some easing in monetary policy. Government bond yields are at levels not seen in decades, and provide compelling yield with little to no credit risk.

Corporate bond spreads offer fair value after years of trading near historical lows

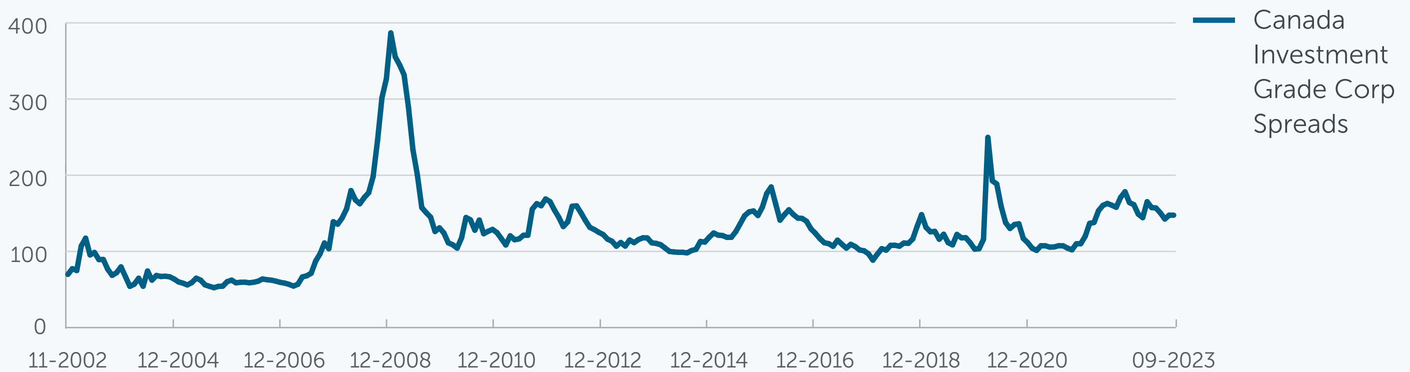
For three out of the last five years, corporate bonds have offered investors historically low spreads/yield pick-up, but now offer investors higher and more attractive spreads in-line with historical medians. These higher spreads, combined with the higher overall rate environment, result in corporate bonds offering investors the highest all-in yields in the last 15-years since the Great Financial Crisis began.[3] We are finding opportunities to buy bonds in this environment of both investment grade and high yield companies, particularly in the front-end of the curve.

These companies offer higher yields given the inversion of the yield curve and we have very high confidence of being repaid in full. Even though balance sheet fundamentals remain strong, we are taking a more balanced approach with corporate bonds, particularly in the high yield, where we have seen some deterioration. After six consecutive quarters where high yield credit rating upgrades exceeded downgrades from early-2021 to mid-2022, downgrades have exceeded upgrades for the last five quarters. In addition, after hovering around historically low default rates of ~1% for all of 2022, the default rate has increased to 3% this year, and most market strategists expect this level to increase in the next year. As with past default cycles, defaults will be heavily skewed by companies with lower quality balance sheets and CCC credit ratings.[4]

[3] Source: Bloomberg as of August 31, 2023

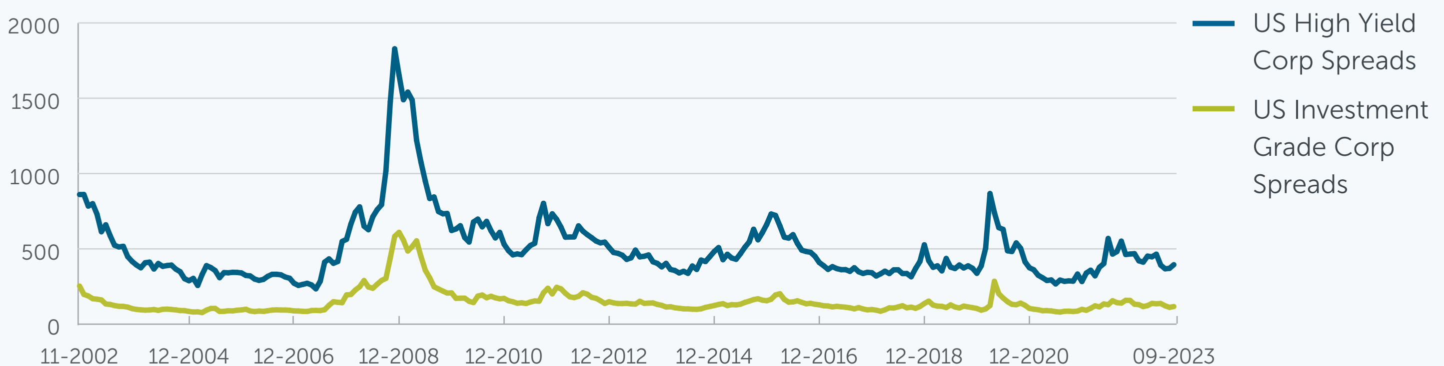
[4] Source: Bloomberg, S&P Global as of August 31, 2023

Canadian Corporate Bond Spreads



Source: Bloomberg, as of September 30, 2023

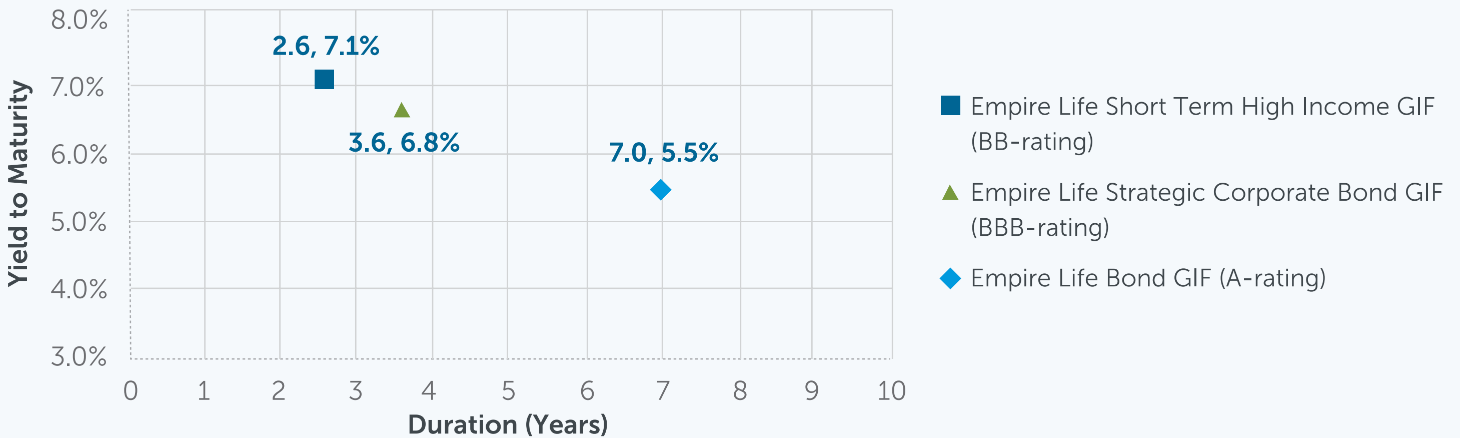
U.S. Corporate Bond Spreads, Investment Grade, High Yield



Source: Bloomberg, as of September 30, 2023

How are our funds positioned?

We have generally been cautious of the enthusiasm with which the market was pricing in central bank action and overall corporate credit risk. Below, we provide an update on positioning for our fixed income GIF offerings.



Source: Empire Life Investments Inc as of Sept 30, 2023. The rating notes for each fund relates to the lowest bond rating of a security that would be considered for each fund's portfolio. Yield to maturity reflects the weighted average yield to maturity of all of the holdings in each respective fund.

Empire Life Bond GIF

As a Canadian core fixed income portfolio, the Empire Life Bond GIF has the most duration (time to maturity) risk (7 years) and lowest credit risk (average credit rating of A) out of our fixed income GIFs. We were underweight duration to start the year as we felt that there were more rate hikes on the way. Similarly, we thought that the market's pricing of rate cuts in 2023 was aggressive and that it was too early in the cycle. As such, we underperformed during the larger rate rallies that we experienced in the first half of the year.

We have maintained our higher weight to credit but maintained a focus on high-grade securities within the portfolio. Shorter-term corporate debt still provides an attractive pick-up in yield, but we have been adding to government bond positions as well. Given more constructive views on duration and government debt, we have extended duration from our previous underweight position to a more neutral 7 years, and are waiting for opportunities to extend duration in a more fulsome manner.

Empire Life Strategic Corporate Bond GIF and Empire Life Short Term High Income GIF

The Empire Life Short Term High Income GIF is positioned to have the least duration risk (2.5 years) and the most credit risk of our GIF offerings (average credit rating of BB), although with less credit risk than the high yield index (average credit rating of B). Meanwhile, the Empire Life Strategic Corporate Bond GIF is positioned between the Bond and Short Term High Income GIFs from both a duration (4 years) and credit risk perspective (average credit rating of BBB).

Throughout 2023, we have consistently maintained this duration and higher overall credit quality mix. Given our cautious stance, we have maintained low levels of CCC-rated exposure (less than 1% for the Strategic Corporate Bond GIF and approximately 1% for our Short Term High Income GIF compared to more than 10% for the high yield index), which unfortunately has been the best performing high yield rating category year-to-date. Given corporate bond valuations are near historical medians and corporate defaults are more likely to increase than decrease, we are maintaining our lower duration and higher quality tilt and will seek to take advantage of opportunities as they arise.

In summary, we continue to be conservatively positioned but continue to monitor forward-looking indicators and the economic data going forward while always looking for new opportunities to deploy capital.

For more information on our award-winning fixed income solutions* contact your financial advisor or visit empire.ca.

* **Empire Life Short Term High Income GIF was awarded the FundGrade A+ award in 2022 for the best-performing fund in its category**. FundGrade A+® is used with permission from Fundata Canada Inc., all rights reserved. The annual FundGrade A+® Awards are presented by Fundata Canada Inc. to recognize the "best of the best" among Canadian investment funds. The FundGrade A+® calculation is supplemental to the monthly FundGrade ratings and is calculated at the end of each calendar year. The FundGrade rating system evaluates funds based on their risk-adjusted performance, measured by Sharpe Ratio, Sortino Ratio, and Information Ratio. The score for each ratio is calculated individually, covering all time periods from 2 to 10 years. The scores are then weighted equally in calculating a monthly FundGrade. The top 10% of funds earn an A Grade; the next 20% of funds earn a B Grade; the next 40% of funds earn a C Grade; the next 20% of funds receive a D Grade; and the lowest 10% of funds receive an E Grade. To be eligible, a fund must have received a FundGrade rating every month in the previous year. The FundGrade A+® uses a GPA-style calculation, where each monthly FundGrade from "A" to "E" receives a score from 4 to 0, respectively. A fund's average score for the year determines its GPA. Any fund with a GPA of 3.5 or greater is awarded a FundGrade A+® Award. For more information, see www.FundGradeAwards.com. Although Fundata makes every effort to ensure the accuracy and reliability of the data contained herein, the accuracy is not guaranteed by Fundata.

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