INVESTMENT
FUNDS

Bonds

QUARTERLY COMMENTARY

March 2023

The bond market has an eventful, volatile quarter

Consequences of rate hikes start to be felt

The year began with a bond rally as investors sensed the Fed was nearing the end of its hiking cycle, a conviction that was borne out when the pace of tightening slowed in January amid a more dovish tone. Meanwhile, the BoC hit a pause on hikes at its January meeting and maintained that posture into March.

Even so, as the first quarter wore on, sticky inflation and labour market buoyancy, combined with an increasingly hawkish Fed, brought yields back up toward their 2022 peak – that is until stress emerged in the banking system in March, with U.S. regionals and Credit Suisse falling victim. Yields dropped and curves steepened on the flight to quality, with weakening economic data extending the trend to the end of the quarter.

There is still work to be done to tame inflation, but we are getting closer to the terminal rate

We expect another U.S. rate hike in May, consistent with the Fed's most recent dot plot, but we think long-bond yields will be capped at present levels owing to the aggressive pace of last year's hikes and indications that the consequences are starting to be felt. We also expect yield curves to be steeper by year-end as the markets start to price in rate cuts in 2024.

Performance analysis

Our underperformance during the quarter was due essentially to our positioning in products with a shorter duration than that of our benchmark. We had overweight positions in the corporate and municipal bond segments, which did not benefit as much as the broad index in an environment of declining bond yields. Moreover, their spreads widened with the U.S. banking turmoil.

Our use of derivatives to modify our duration stance and/or to take advantage of diverging movements between Canadian and U.S. yields detracted from the portfolio's performance. On a positive note, our positions in the federal and provincial segments were favourable because we held bonds with a duration exceeding that of our benchmark.

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Alexandre Morin, CFA

Senior Director, Portfolio Manager, Fixed Income

- Joined iAIM in 2015
- More than 20 years of investment experience
- Bachelor's degree in Business Administration, Université Laval

Longer duration and overweight in quality credit

"We currently have a longer duration in our portfolio versus its benchmark because we expect further economic deceleration in the coming months."

We also had an overweight in quality credit because spreads had widened quite a bit since the beginning of last year. We also continued to overweight non-rated bonds issued by Quebec municipalities for their excellent carry and low interest rate risk. The bond market is still very volatile, so nimbleness will be key when opportunities arise to add value to our portfolios.

Key Takeaways

- Bond yields are very volatile amid ongoing hawkish comments from central bankers.
- Regional banks may be the first victims of the rapid rate increases.
- We favour a longer duration and an overweight in quality credit vis-à-vis the benchmark.

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