INVESTMENT FUNDS

Bonds

MONTHLY COMMENTARY

August 2022

Mid-summer dreams of a U.S. Fed pivot give way to the realities of persistently high inflation

The largest drawdown since 1990

August was not easy for fixed income investors, as shown by the 20% drawdown of the Bloomberg Global Aggregate Total Return Index for bonds by the end of the month from its peak in July 2021. In that context, 10-year Treasuries' yields moved off the recent lows recorded in July and shot up roughly 50 basis points in August to close at about 3.25%.

In a speech at Jackson Hole, U.S. Federal Reserve Chair Jerome Powell underscored his determination to rein in inflation, acknowledging that tighter monetary policy may cause an economic slowdown but noting that failing to check rising prices would be more harmful. Such pointedly hawkish sentiment from the Fed pushed the markets closer to pricing in another 75-basis-point hike at the September 21 meeting. The 2s-30s yield curve in the United States flattened by 20 basis points in August because of the Fed's professed vigilance.

The tone in Canada was similar, as 10-year Canada yield backed up roughly 40 basis points during August to 3.10% and the 5s-30s yield curve flattened by 40 basis points to end the month inverted by 25 basis points. Investors were even more gloomy about the Bank of Canada's September 7 meeting, pricing in a hike of 75 to 100 basis points.

A difficult environment for risk assets

The backup in yields during August eventually weighed on risk assets, slanting the pendulum toward the notion of a fizzling bear market rally rather than the ushering-in of a new bull. After bottoming out at about 450 basis points in mid-August, high-yield spreads gave up 75 basis points in the latter half of the month, rising closer to 525 basis points. Investment-grade (IG) spreads were more flattish in the month, but a host of issuance imputed generous new deal concessions into transaction flows. And even though corporate earnings reports during the month were not as bad as feared, concerns about the impact of inflation and slowing demand on profitability became more prominent.

Performance: positive contributions from corporate and municipal bonds

The broad index returned -2.74% in August, deepening the year-to-date loss to -11.31%. With the longest duration, provincial bonds registered the worst performance, down 3.44%, while corporates lost 1.95%. For its part, the federal segment incurred a loss of 2.62%.

The Fund's most important contributor was its positioning in the corporate bond market. We overweighted this asset class, which outperformed the index because of its shorter duration. Also, our portfolio holds bonds that are of higher quality than the average of those in the index.

A second contributor was our municipal bonds. Most of our municipal bonds were issued by non-rated municipalities in the Province of Quebec. They bear a short duration, which has been positive in the context of rapidly rising bond yields.

The two main detractors from the Fund's performance were our positioning in the federal and the provincial segments. Most of the underperformance is due to the longer duration of our bonds in relation to the index.

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

Favouring a longer duration in the central banks' tightening cycle

10-year U.S. Treasuries' yields are rapidly approaching the 3.50% mark previously touched in mid-June. The brisk monetary policy tightening cycle orchestrated by central banks should rapidly weight on the economy, prompting us to opt for a longer duration than our benchmarks in the coming months. As usual, we will stay nimble because the extreme volatility still present in the bond market will provide us with opportunities to modify our duration proposition.

> "We recently unwound our flattening bias because we think the Bank of Canada will slow the pace of its rate hikes after its September meeting, making the flattening positioning less compelling."

Also, the autumn is usually a busy season for new investment-grade corporate issues in the 30-year segment, which could weight on bond yields in this part of the curve.

Finally, we are overweight provincial, municipal and corporate credit, considering that spreads have widened significantly since the start of the year.

As part of our strategy to combat price swings in the bond market, we continue to overweight non-rated bonds issued by municipalities in the Province of Quebec, owing to their lower interest rate risk and very good carry.

Key Takeaways

— Central bankers set the record straight, with U.S. Federal Reserve Chair Jerome Powell making it clear that a pivot is not in the cards.

— Risk assets responded negatively to these hawkish comments.

— The Fund's duration is a little longer than its benchmark; we think most of the curve flattening is behind us.

About iAIM

A magnet for top investment talent, iAIM is one of Canada's largest asset managers, with over $100 billion under management across institutional and retail mandates. We help investors achieve their long-term wealth creation goals through innovative investment solutions designed for today's complex markets. We are building upon our historic success, supporting the growth of our core strengths and exploring innovative ways to meet investor needs. We are rooted in history and innovating for the future. Our experienced portfolio managers use a proprietary investment methodology, rooted in iAIM's unifying commitment to strong risk management, analytical rigor and a disciplined, process-driven approach to asset allocation and security selection.

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