CUMBERLAND
Private Wealth

FIXED INCOME - FIRST QUARTER 2021

Patience is a Virtue

"Are we there yet?" It's been more than one year since much of our society started working from home. Clearly, life is still not "normal" and it is very unclear what the "new normal" will look like or when we can say the pandemic is behind us. Everyone's patience has been tested and is still being tested. Vaccination in Canada is rolling out at an embarrassing snail's pace compared to other countries. As warmer weather approaches for Canada, provincial governments are concerned that it will lure people to venture outside more and gather socially. New variants are on the rise and we are seeing evidence in the positive test numbers that yet another wave is developing. I'm losing count which wave this is, as life has not changed much over the last 12 months for me, everything is pretty "boring" and routinely the same.

Let's recap the COVID-19 stats in Canada (since the beginning of the pandemic to Mar 31st 2021):

28MM people tested, with 14.1MM in Q1 (increase of 102% since the end of 2020)

987,666 people confirmed to be infected, an increase of 414,684 cases in Q1 alone

22,956 people have died to date, with 7,214 deaths in Q1 (a jump of 45% from Q4 2020)

4,989,821 people vaccinated with one dose (13% of the population).

685,653 people fully vaccinated (1.8% of the population).

Source: https://www.canada.ca/en/public-health/services/diseases/2019-novel-coronavirus-infection.html

While the number of Canadians taking their first shots has accelerated over the last couple weeks, the issue remains when the Canadian society will achieve herd immunity and if the vaccinations will be successful against the increasing spread of new variant cases. Many of the second doses for Canadians are scheduled 3 to 4 months out from the initial dose, far outside of where Health Canada approved the vaccination with second doses being taken within 4 weeks. We shall see if this government science experiment with these delayed second doses is going to be effective.

We did see some new market related highs (noted in Exhibit 1) this quarter, as vaccines rolled out globally and government began easing restrictions.

Exhibit 1: Market Indicators			
	Dec 31, 2020	**Mar 31, 2021**	**Comments**
WTI Crude Oil (USD)	$48.23/bbl	**$59.46/bbl**	+23% as OPEC continues to be cooperative in keeping a lid on its production
S&P 500	3,730	**3,972**	+6.5% from optimism of vaccine rollouts and solid Q4 earnings
S&P/TSX	17,433	**18,701**	+7% with higher interest rates and energy prices helping financials and energy sector recover
Price of Gold (USD)	1896	**1707**	-10% with oil and financial markets being supportive, people did not feel the need to "hide" in gold for stability
Currency (CAD/ USD)	0.7840	**0.7961**	+1.5% continued appreciation with the move in oil
10 Year Government of Canada Bond Yield	0.677%	**1.56%**	+130% move in bond yields for the quarter as investors worried about reflation as the government will continue to need to print more money to combat the pandemic.

Source: Bloomberg

Bank of Canada Scales Back on Provincial and Corporate Bond Buying Programs

In January, the Bank of Canada signaled its intention to reduce the buying of Government of Canada securities from $4billion/ week once they gained confidence in the strength of the recovery. The expectation from economists is that the Bank of Canada will taper as early as April to $3bln/week but the Bank is reviewing its options to try to have an orderly retraction.

On Feb 23rd, the Bank of Canada reduced its buying of provincial bonds in the secondary market from twice a week to once a week and reduced the maximum from $500MM to $350MM. Since the beginning of the program, the Bank of Canada has purchased a total of $17bln out of a potential of $38bln (about 46% of the maximum). The program will not be renewed at the end of its one-year anniversary on May 7th. With the Bank of Canada scaling back on provincial bond buying, it should be interesting, given the elevated levels of issuance the provinces still need to complete (discussed below). We see this having negative implications on spreads for provincial bonds if the market feels all-in yields get too low and there is no government support to absorb the excess.

Similarly, the Bank of Canada also reduced their eligible secondary buying of corporate bonds from $200MM per week to $100MM per week, while still maintaining purchases twice a week. Since the start of the pandemic, the Bank of Canada has purchased $254MM out of a potential $8.3bln (approximately 3%). Similar to the provincial bond buying program, during the quarter, the Bank of Canada announced the program would not be renewed and will end on May 26th. With the limited utilization of this program, there should be little impact on the corporate bond market from an operational standpoint to enable issuers to have liquidity (given the companies that were eligible for support have mostly refinanced and termed out bond maturities). Also, with record low all-in yields, investors have been gravitating to corporate bonds for higher yields vs. government (federal and provincial) bonds. From a performance stand-point, in terms of spreads, on this announcement and the continued issuance of corporate bonds during March, we saw spreads widen. We expect there could be further spread correction if supply gets too overwhelming for the market to absorb (which is normal bond market supply/demand conditions) as issuers are still lured to lock in longer term all-in low interest rates.

Government Debt Issuance Update

Why do we need to care? At some point, we, as taxpayers will need to deal with the ballooning level of federal and provincial government deficits.

Alberta, Ontario, Quebec, New Brunswick, Nova Scotia and Prince Edward Island have all released their borrowing requirements for the Fiscal 2021/2022 period. In the table below the green highlights are estimated figures from National Bank. While most borrowing requirements will be lower than Fiscal 2020/2021, levels are still quite elevated from pre-covid levels to the tune of +40% to almost +200% (in the case of Alberta).

Exhibit 2: Government Borrowing Requirements

In $ Billions	Fiscal[1] 2019/2020	Fiscal 2020/2021	Fiscal 2021/2022	F2021/2022 Growth	
	Completed	Completed	Total Expected	From F2020/2021	From F2019/2020
Government of Canada	114	374	**275**	-26%	141%
Provincial Borrowings					
British Columbia	5.7	14.4	**12.0**	-16%	112%
Alberta	7.6	25.8	22.5	-13%	198%
Saskatchewan	1.9	4.5	**3.5**	-23%	84%
Manitoba	4.3	8.6	**7.0**	-18%	65%
Ontario	39.5	59.0	54.7	-7%	39%
Quebec	20.0	37.8	28.5	-25%	42%
New Brunswick	1.9	1.7	1.9	9%	-4%
Nova Scotia	1.5	2.2	2.2	2%	47%
P.E.I	0.1	0.3	0.2	-20%	100%
Nfld & Labrador	1.2	2.8	3.0	7%	150%
Total Government Debt Issuance	198	531	410	-23%	108%

Source: National Bank Financial, Bank of Canada
Notes:
1. Fiscal Year April 1-Mar 31
Green highlighted areas are estimates until budgets are released

Exhibit 3: Upcoming Government Fiscal 2021/2022 Budget Release Dates

Saskatchewan	April 6, 2021
Manitoba	April 7, 2021
British Columbia	April 20, 2021
Federal	April 19,2021

Source: National Bank Financial, Bank of Canada

Bank of Canada to Increase Overnight Rates Sooner Than 2023?

During a speech on February 23, 2021, Governor Macklem said "I began this speech by highlighting the health of Canada's labour market before the pandemic. Unemployment had been around 40-year lows for a couple of years. Based on past economic cycles, we would have expected inflationary pressure to begin to rise. But inflation wasn't threatening to take off. As the pandemic recedes and the recovery continues, we will keep that experience in mind. Monetary policy can continue to support demand in order to minimize scarring and bring as many people into the work force as possible."

Governor Macklem has been pretty consistent with his messaging. During its last Bank of Canada meeting on March 10th, he reiterated that the Bank of Canada will continue to be supportive and will not look to increase the overnight interest rate until the economic recovery was well underway and inflation of 2% is "sustainably achieved". As noted in my last quarter's review, while we will very likely see near term spikes in inflation above the 2%, the issue will be if that level of 2% is sustainable. Particularly for inflation, we are already seeing increases in energy prices (typically policy makers look through energy-price volatility) and in consumer goods (building products, furniture and others as supply chains continue to be disrupted). However, offsetting energy and consumer goods rising prices, rent, mortgage costs and electricity have dropped and commodities prices have also cooled. While there is the expectation that we may see a spike in inflation come through in the April/May/June data (which data lags by a month), we would still be 1.5 years away from 2023. For the Bank of Canada to confirm "sustainability achieved" we need a good timeframe of data, potentially 3 to 4 quarters, before an increase in rates is proposed. So whether they jump the gun in late 2022, we will have to wait and see. Let us just hope that the Canadian population can reach herd immunity against COVID-19 before the beginning of 2022 at this point!

US Welcomes Joe Biden as its New President

The 46th President of the United States, Joe Biden, was sworn-into office in January as the Democrats regained power in the White House. They were quick to pass through one of the largest economic rescue plans in U.S. history - the $1.9 trillion stimulus package which authorizes new federal spending and temporary increase in anti-poverty programs to help families struggling during the pandemic.

One notable item to consider with the change of Presidents is that with the expiry of term for the Chairman of the Federal Reserve coming up next year, we may see Jerome Powell's term extended post February 2022.

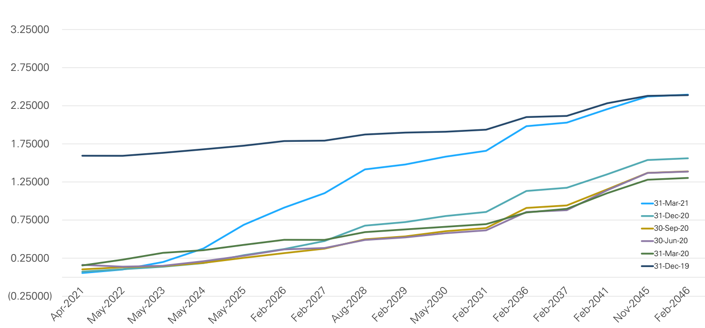
Quarter Review

During the quarter, the Federal Reserve ("the Fed') kept interest rates unchanged at 0% (lower bound) in Q1. The expectation is that the Fed will keep interest rates at the lower bound until 2023 when they project there will be an improvement in unemployment levels and inflation averages 2% over time. US interest rates for the quarter were higher anywhere between 6bps[2] to 86bps with longer dated government bonds moving the most.

The Bank of Canada kept their overnight rate unchanged in Q1 at 25bps. Similar to the Fed, the Bank of Canada will keep overnight interest rate unchanged for the medium term and projected no movement in overnight interest rates until 2023.

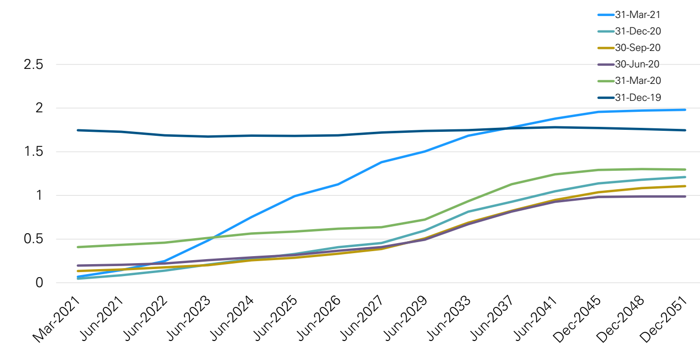
2. Bps means basis point. 1bps equivalent to 0.01%

Exhibit 4: US Yield Curve



Source: Bloomberg

Exhibit 5: Canada Yield Curve

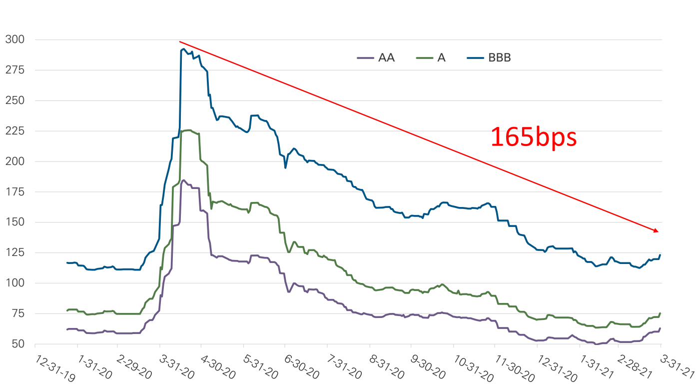


Source: Bloomberg

Canadian government interest rates for the quarter were higher anywhere between 2bps to 93bps, with the 7-year part of the curve moving up the most. The differential between the 2-year and 10-year government bonds is at its highest (steepest) in the past 5 years at +123bps. The yield volatility of the 10-year Government of Canada bond was higher than in previous quarters with a move of more than 140% (peak to trough) vs. peak volatility in 2020 of 68% in Q1/20 when interest rates were rapidly cut. New investment grade corporate issuance continued to be strong in the quarter in Canada at $32bln vs. $28bln in Q1/20 (+14%). We saw many corporate issuers take advantage of the all-in low interest rates to refinance and extend shorter dated maturing bonds and also just be opportunistic to call bonds with higher coupons to refinance at lower coupons. Canadian investment grade corporate spreads were mixed on performance with BBB bonds performing the best (tighter anywhere between 2bps to 10bps across the curve) and 30-year bonds tightening the same across rating categories during the quarter. AA and A bonds shorter in duration actually were wider anywhere between 2bps to 10bps in the quarter.

Spreads widened out very quickly during the beginning of the pandemic in March (see Exhibit 6 below), but have since narrowed by as much 165bps since peaking and are now back levels at the start of 2020 (in some instances even tighter). Note that a 165bps change is equivalent to about a 7% price adjustment for a 5-year bonds. During the quarter though, we did see spreads tightest just prior to the Bank of Canada announcing they would not renew the Corporate Bond Buying Program. 5-year corporate spreads are about 10bps to 13bps wider since that announcement on February 23rd.

Exhibit 6: 5-Year Investment Grade Corporate Spreads



Source: BMO Capital Markets

Returns for various fixed income asset classes are shown in the table below.

Exhibit 7: Returns for Fixed Income Asset Classes

Asset class returns	Q1/21	Q1/20	2020	2019
Bond Universe Index	-5.04%	1.56%	8.68%	6.87%
Corporate Bond Index	-3.50%	-2.48%	8.74%	8.05%
FTSE High Yield Canadian Index	2.22%	-10.53%	6.69%	8.48%
S&P/TSX Preferred Index	12.12%	-24.86%	6.11%	1.99%

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Outlook & Strategy

Patience is a virtue – and I have been sounding like a broken record for many quarters now by continuously highlighting the number of bonds that are trading above par and how low yields are. Because bonds are not like equities – bonds have limited upside as they revert to par upon maturity but can also trade below par during its tenor. This past quarter showed us again that volatility is real and that price and yields can change quickly.

At the end of the Q1 2021, 88% of the bonds in the Canadian Bond Universe traded above par vs. 99.5% at the end of 2020. All-in bond yields ended the quarter higher with the sell-off in bonds. The Canadian Bond Universe Index now yields 1.72% vs. 1.21% at the end of 2020. Clearly the market needed to take a breather and we believe there could be a bit more downward prices pressure (higher yields) to come. Now is the time to start to selectively lock-in better all-in yields as the yield curve has steepened and given where some bonds are now trading, we can avoid capital losses. While the rollout of vaccines has been delayed from initial indications, we are still moving in the right direction to seeing economic improvement. We anticipate that no path forward will be easy and while there may be some bumps along the way for Canada to get to herd immunity, we will slowly navigate over or around them to keep to our strategies of preserving your capital and managing your overall risk.
Spring is here! Looking forward to seeing you virtually at our next client quarterly event on April 20th!

Take Care,
Diane Pang

Lead Manager,
Cumberland Fixed Income*
April 1, 2021

*Cumberland Private Wealth refers to Cumberland Private Wealth Management Inc. (CPWM) and Cumberland Investment Counsel Inc. (CIC). Diane Pang (a Portfolio Manager at CIC) is the lead portfolio manager for the Cumberland Income Fund and the Kipling Strategic Income Fund. NCM Asset Management Ltd. (NCM) is the Investment Fund Manager to the Kipling Strategic Income Fund. CPWM, CIC and NCM are under the common ownership of Cumberland Partners Ltd.