



## FIXED INCOME - SECOND QUARTER 2021

### Accelerated Progress – But Let's Not Totally Let Our Guard Down

Covid-19 fatigue is real. There has been so much conflicting news, that people have just started tuning out. For instance, to mask or not to mask: CDC is suggesting that no masks are required for fully vaccinated individuals, but yet WHO is still suggesting that a mask should still be worn for fully vaccinated individuals for better prevention against the Delta variant<sup>1</sup>. Even in Canada, there has been some flip flopping regarding the use of the AstraZeneca vaccine about its safety and more recently, the push to mix and match vaccines in an attempt to push for herd immunity. Who can follow all of this and what is believable? Well, the one thing that is positive is Canada has made great progress in vaccinations over the last quarter! Whether or not it's the right step forward on their methods, vaccinations have accelerated during the quarter with 67%<sup>2</sup> of the Canadian population receiving 1 dose and 31%<sup>3</sup> of our population now being fully vaccinated. Provinces are staggering re-opening over the coming weeks with targets of being fully operational by the fall. Vaccinations do seem to be working in terms of limiting the severity of Covid-19 (and variant) symptoms, reducing hospitalizations and increasing the confidence of society to be more active.

Let's review the COVID-19 stats<sup>4</sup> in Canada (as at June 30th from the beginning of the pandemic):

**37.1MM** the number of people tested, with 9.1MM in Q2 (increase of 33% since the end of Q1/2021)

**1,415,237** the number of people confirmed to be infected, with an increase of 427,571 cases in Q2

**26,294** The number of people who died, with 3,338 deaths in Q2 (improvement from the 7214 deaths in Q1)

Vaccinations in the US have plateaued (at around 47% of their population being fully vaccinated) as reopening is in full swing across the States. We continue to see investment markets confirm the general feeling of optimism for the most part. Bonds told a bit of a different story though, partly because Central Banks continue to intervene with quantitative easing and yield curve control, which not surprisingly, is why yields continue to stay low.

Notes:

1. <https://qz.com/2025962/who-guidance-is-to-wear-masks-against-delta-variant>
2. <https://covid19tracker.ca/vaccinationtracker.html>
3. *ibid.*
4. *ibid.*



### Exhibit 1: Market Indicators

	Mar 31, 2021	June 30, 2021	Comments
<b>WTI Crude Oil (USD)</b>	<b>\$59.46/bbl</b>	<b>\$73.56/bbl</b>	+24% on the quarter as OPEC continues to be cooperative in keeping a lid on its production and demand picks up globally as countries re-open
<b>S&amp;P 500</b>	<b>3,972</b>	<b>4,298</b>	+8.2% led by strong Q1 earnings but also with investors continuing to borrow to buy into the markets
<b>S&amp;P/TSX</b>	<b>18,701</b>	<b>20,166</b>	+7.8% with higher short-term rates and commodity prices helping
<b>Price of Gold (USD)</b>	<b>1707</b>	<b>1769</b>	+3.6% general support of commodities across the board and inflation fears being kept at bay
<b>Currency (CAD/USD)</b>	<b>0.7961</b>	<b>0.8066</b>	+1.3% continued appreciation due to strong move in Oil and other commodity prices
<b>10 Year Government of Canada Bond Yield</b>	<b>1.56%</b>	<b>1.39%</b>	-10% move in bond yields for the quarter as Bank of Canada continued to be cautious, continuing quantitative easing (bias to long end) and backing the call of transitory inflation

Source: Bloomberg

## Bank of Canada Tightening - Another Sign We Are Moving in the Right Direction

As anticipated, this quarter, the Bank of Canada reduced its purchases of Government of Canada securities from \$4 billion/week to \$3 billion/week. There are rumors of further tightening to be announced in the coming weeks, which will further reduce to \$2 billion/week. We expect the Bank of Canada to continue to ensure an orderly retraction.

In addition, during the quarter, both the Provincial and Corporate Bond Buying Programs expired as was announced in Q1, neither of which impacted spreads for the quarter as demand for yield continued and in fact, spreads tightened for both classes of securities.

The Bank of Canada's total assets are now at \$477 billion vs. a peak of \$575 billion as at March 10, 2021 and a low of \$120 billion prior to the start of the pandemic.

## Bank of Canada Monetary Policy Report Optimistic, But Still A lot of Uncertainty and Potential Downside

Every January, April, July and October, the Bank of Canada releases their Monetary Policy Report which outlines base-case projections for inflation and growth in the Canadian economy, and its assessment of risks. April was the most recent report issued and it was overly optimistic given the adjustments to projected 2021 GDP jumped from 4% to 6.5%. As a result, this got bond markets excited that a hike in the overnight interest rate could come sooner than 2023 (potentially late 2022) as short end rates moved higher but with quantitative easing still in place, longer-term rates moved lower. There is a dependency on a few key assumptions that if they don't materialize could disappoint on the downside:



1. **Easing COVID-19 restrictions by end of May.** Easing was a bit delayed for most provinces to late June/early July. Also, vaccinations, while delivery accelerated, herd immunity against COVID-19 and its new variants is still on an uncertain timeline. In addition, the issue with Canadian mixing and matching their vaccines between their first and second shots has no formal studies to show the protection level as this is all experimental, nor the effectiveness when second shots are delayed from manufacturer's studies and then mixed with another vaccine. While 67% of the population has received their first shot, the effectiveness of only 1 dose of AstraZeneca or Pfizer has shown to be at best 33.5%<sup>5</sup> effective against the Delta variant in studies done in the United Kingdom (Delta is the variant that Canada is seeing spreading most rapidly across the country at this point). With two doses of AstraZeneca or Pfizer, the level of protection increases to 60% and 90% respectively<sup>6</sup> against the Delta variant. Unfortunately, there have not been studies yet regarding the effectiveness of mixing and matching vaccines against the Delta variant, so this is still a big question with "fully vaccinated" individuals who mixed and matched. While Canada is still in the process of getting its population fully vaccinated, the new variants are still emerging around the world like the Delta Plus, and as we start the re-open, it is still a wait and see if spread of the virus will continue and how severe symptoms will be that may require another lockdown.
2. **Federal fiscal stimulus is currently estimated at \$85 billion** (in January's report it was estimated to be \$70 billion). The range given by the government was \$70 to \$100 billion in the Fall Economic Statement 2020. If there are any hiccups with point number one above, there could continue to be issues and Federal fiscal spending may be at the higher end of the spectrum.
3. **Oil prices are 20% to 43% higher** in this report vs. January. Note that the Bank of Canada does not forecast oil prices but uses current prices. While prices have continued to climb from the US\$60/bbl WTI Crude that was used in the April report to today's US\$74/bbl WTI, there is risk that Oil could reverse back down under US\$60/bbl. What has helped with rising prices is OPEC has been cooperative in continuing to cut production to prop up prices and global demand has picked up as countries ease restrictions. There is a medium-term risk that OPEC will no longer want to cooperate if it sees supply from other countries come into the market to fill the demand. In addition, with new waves of COVID-19 emerging and potentially having to increase restrictions again in countries, this could reduce the anticipated higher demand for oil.
4. **CAD/US exchange rate was 2% higher** than the January report at 80 cents US vs. 78 cents. The Bank of Canada also does not forecast the exchange rate but rather uses the current rate. As a result, there is a risk here if there is retraction to the rate going forward. This rate is highly correlated with oil prices and will also appreciate if Canada increases overnight interest rates earlier than the US.
5. **Supply issues** – There have has been global supply chain issues and most notably with the microchip supply that has stalled production in electronics devices, appliances and cars. Lumber demand outstripped supply during the quarter with prices up 67%, but they have come down about 30% since the start of the quarter<sup>7</sup>. There are other issues for other industries (ie. try buying a bicycle or people are stealing catalytic converters off cars to harvest for their precious metals). While some may think these issues are menial, they could cause a risk to the GDP forecasts going forward (manufacturing is about 9% and housing is about 13% of GDP)<sup>8</sup>.

5. <https://www.theglobeandmail.com/canada/article-variant-that-emerged-in-parallel-with-vaccines-poses-a-different-kind/>

6. *ibid.*

7. LBI COMB Bloomberg

8. <https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3610043402>



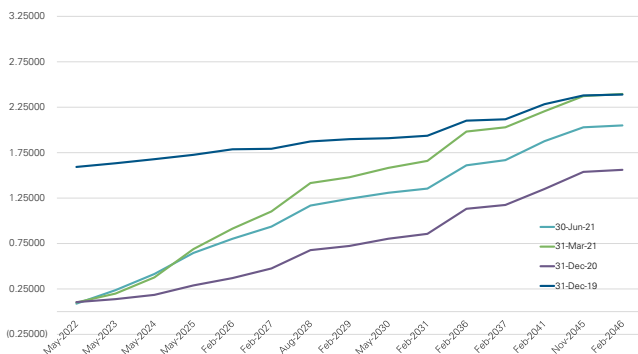
While we anticipate the upcoming July report will be remain optimistic, the bigger issue is if Oil and our currency will remain at these levels for future reports which will impact 2022 projections and then for late 2022 lift-off of overnight interest rates. Additionally, the big unknown is still, when we do fully re-open, will another wave start that will require another slowdown or lockdown?

Given all of this above, the Bank of Canada is still cautious but now sees inflation hitting their sustainable 2% level by late 2022. The market is just too focused on headline inflation and trying to gauge if it's transitory or not, and whether the near-term heat will be enough to push the central banks to increase overnight interest rates. While a sustainable inflation target of 2% is not the only thing that will drive the Bank's decision to hike interest rates, the goal is to also maximize employment. As a reminder, the unemployment rate was 8.2% at the end of May, which is still higher than the 5.7% we saw back in February 2020 (pre-pandemic). Currently, the Canadian Emergency Response Benefit (CERB) will start phasing out at the end of August, with a final end date of September 25, 2021. Individuals can transition to unemployment insurance post that if eligible. What we are seeing with the reopening in the US and them trying to get workers back into the workforce is that there is a both a skills mismatch to job openings and little incentive for the unemployed to go back to work early while government subsidies are still available. Employers are not only giving out recruitment incentives, they are luring people with monetary incentives to just come out for an interview! We shall see if this phenomenon makes it way north of the border. Either way, watching the unemployment rate is going to be key and how quickly that reverts back to a reasonable level.

### Quarter in Review

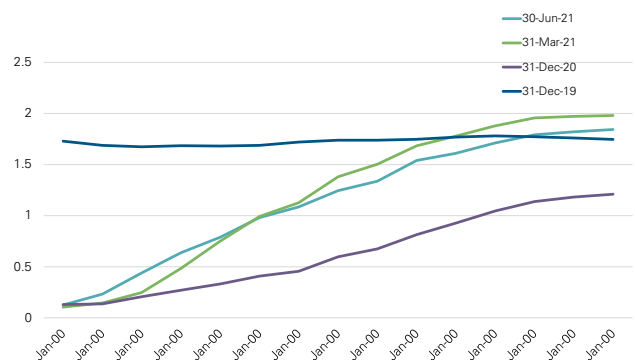
During the quarter, the Federal Reserve ("the Fed") kept interest rates unchanged at 0% (lower bound) in Q2. The market expects the Fed will keep interest rates at the lower bound until late 2022, however the FED has cautioned that they will be supportive until the recovery of the economy is well underway. US interest rates for the quarter were higher in the short end (less than 5 years) about 4bps<sup>9</sup> and lower in the long end (over 5 years) anywhere between 4bps to 37bps.

Exhibit 2: US Yield Curve



Source: Bloomberg

Exhibit 3: Canada Yield Curve



Source: Bloomberg

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



The Bank of Canada kept their overnight rate unchanged in Q2 at 25bps. Similar to the Fed, the Bank of Canada will keep the overnight interest rate unchanged for the medium term and projected in their latest April Monetary Report that recovery is underway in late 2022 (risks to assumptions discussed above).

The Canadian government interest rates curve was flatter for the quarter. Interest rates were mixed with the short end (5 years and under) higher anywhere between 2bps to 19bps, and longer-term rates (over 5 years) lower anywhere between 1bp to 17bps. The differential between the 2-year and 10-year government bonds was flatter by 32bps. The yield volatility of the 10-year Government of Canada bond was actually lower than in previous quarters with a move of 17% (peak to trough) vs. last quarter at a record 140%.

New investment grade corporate issuance continued to be strong in the quarter in Canada at \$42 billion vs. \$47 billion in Q2/20. We continue to see 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 tighter for the most part between 2bps to 10bps with the exception of 10-year A rated bonds that were 2bps wider.

Spreads widened out very quickly during the beginning of the pandemic in March (see Exhibit 4 below), but have since narrowed by as much 174bps since peaking and are now back levels at the start of 2020 (in some instances even tighter). Note that a 174bps change is equivalent to about an 8% price adjustment for a 5-year bonds.

**Exhibit 4: 5-Year Investment Grade Corporate Spreads**



Source: BMO Capital Markets

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

**Exhibit 5: Returns for Fixed Income Asset Classes**

Asset class returns	Q2/21	Q2/20	2020	2019
Bond Universe Index	1.66%	5.87%	8.68%	6.87%
Corporate Bond Index	1.28%	8.09%	8.74%	8.05%
FTSE High Yield Canadian Index	2.60%	7.62%	6.69%	8.48%
S&P/TSX Preferred Index	5.68%	14.96%	6.11%	1.99%



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## Outlook & Strategy

We continue to harp on finding relative value in bonds and being ‘picky’ in terms of what we are prepared to invest in. While this quarter the bond market was in a bit of a limbo, we continued to be proactive in looking for opportunities that are in line with our strategy – locking in yield where it makes sense. We also continue to be patient. The number of bonds trading above par in the Canadian Investment Grade Bond Universe was 88% at the end of the quarter (unchanged from Q1). Volatility was more at bay this quarter, with no real catalysts for further moves in either direction until we continue to see inflation stabilize (and not just one more ‘print’ but a series of ‘prints’) and unemployment retrace, which is more a wait and see game for a few quarters vs. a day to day or month to month at this point. So, while there are many impatient onlookers wanting more, we have to be patient. In the interim, we are selective as to where to invest during this period and finding pockets that will be less volatile when markets move (our anticipation is that interest rates in the medium term will be higher). Note that our strategy for returns is not predicated on having high volatility to deliver investors’ return. Actually, our preference is to have low-volatility, so we can earn decent levels of income from interest. That said, we are, however, positioned to minimize the volatility we experience in the markets.

The Canadian Bond Universe Index now yields 1.72% (unchanged from the end of Q1), but we target a yield above that for our strategies.

With the continued progression of Canada’s vaccination campaign, hopefully this will curb the spread of the variants of Covid-19 and make the path to a new normal easier. Happy Canada Day and enjoy your summer!

Take Care,  
Diane Pang

Lead Manager,  
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July 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.

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