FIXED INCOME - THIRD QUARTER 2021

Boomerang- Lackluster Quarter

The first 2.5 months of the quarter were lackluster for the most part as markets moved quietly and slowly in a positive direction. Maybe most people just wanted to enjoy summer and not worry or even think about the markets. As summer started to wind down, unfortunately Covid-19 did not: cases started to spike again. Also, by mid September investors woke up and found reasons to focus their attention on lingering issues that would teeter the markets: the US debt ceiling expiration and the ability of one of China's largest real estate developers, Evergrande Group, to pay some hefty interest payments on their debt obligations.

COVID-19 Update

Canada has made great strides since the last quarter in getting Canadians vaccinated: a whooping 70.7%[1] of the population is now double vaccinated, lifting Canada to the top 10 countries[2] with the highest percentage population double vaccinated in the world.

Is this helping? Well, yes and no. Covid-19 infection rates troughed in Q2 because most provinces mandated lockdowns and tighter restrictions. As provinces opened up in Q3, cases started to spike again, particularly in recent weeks as the Delta variant and other new variants emerged. Ontario, which as a province, was slower out of the gate to re-open than many of the other provinces during the quarter, has seen Covid-19 cases creep up but the severity of the infection seems to be lower as there are less 'active' cases in the ICU. While cases are increasing from Q2 lows, cases are still lower than peak levels seen earlier this year[3]. Recent positive rates in Ontario are showing on average 20-30% of double vaccinated individuals are still testing positive for Covid-19 and another 20% are children under the age of 12. Alberta and Saskatchewan, who were less restricted than Ontario during the start of the quarter (Alberta easing all restrictions pretty much on July 1), have seen elevated infection rates by quarter end that have caused their respective premiers to mandate increased restrictions. Given that each province is acting unilaterally, economic recovery is harder to track and forecast for the nation at large.

U.S. Debt Ceiling

On September 21st, the Democrats in the House of Representatives passed a bill to suspend the US' borrowing limit until the end of 2022, which was then sent to Senate to be voted on. Needless to say, it was rejected. The bill, after a couple revisions, was passed as a nine-week stopgap funding bill. The Democrats were unsuccessful in passing a bill to suspend the debt-ceiling, which would provide more market certainty, rather than kicking the can down the road into the Christmas holiday season. Janet Yellen had estimated that the US would run out of money by October 18th unless action was taken to suspend or increase the federal debt limit. The bill now allows the US federal government to be kept open through to December 3rd.

Notes:
1. https://covid19tracker.ca/vaccinationtracker.html
2. https://ourworldindata.org/covid-vaccinations
3. https://canadiancriticalcare.org/COVID-19-Case-Counts

Evergrande Group

Evergrande Group was topical as September hit and markets watched whether China's second largest real estate developer would be able to meet their pile of debt obligations. Eight of the world's ten most indebted property developers are based in China according to a June report by Bloomberg, and real estate/construction accounts for about 29% of China's economic output. Evergrande is a large, intricate company with many subsidiaries in addition to its real estate development arm. Many reports cited they had 778 projects under construction in 223 cities and about Rmb1.97tn in liabilities with Rmb572bln (USD$89bln) borrowed from banks and bond markets within and beyond China. During the week of September 20th, the company had about USD $165MM of bond interest payments due between US$ denominated bonds and yuan denominated bonds[4]. Negotiations could have been made with counterparties as the company had a 30-day grace period before a technical default would be declared if no payment was received by its bondholders. While there was no direct disclosure from the company regarding if payments were made or not, there have been newspaper articles suggesting that some negotiations had taken place with its domestic debt holders. By September 29, Bloomberg reported that Evergrande Group sold down a 20% stake in Shengjing Bank Co. to the government, with the proceeds of US$1.5bln to settle debt with lenders. This story will continue to evolve as they may have skirted a technical default with the sale of their stake in Shengjing Bank, but the proceeds need to last until the company is able to complete projects to realize value in them. Stay tuned!

Market Indicators

The quarter ended in a 'risk off' tone in the markets from revived Covid-19 concerns, the U.S. debt ceiling expiry, and the Evergrande debt situation. The winds were taken out of the sail to bring markets back to almost where they started at the beginning of the quarter. Below (Exhibit 1) are some market indicators that we continue to follow.

Exhibit 1: Market Indicators

	June 30, 2021	Sept 30, 2021	Comments
WTI Crude Oil (USD)	**$73.56/bbl**	**$75.03/bbl**	+2% on the quarter as OPEC and parties have kept production at bay and even lower than their allowed limits (ie. Russia)
S&P 500	**4,298**	**4,308**	Almost flat for the quarter as risk-off sentiment in the final days of the quarter reversed the 5.5% gain seen at market peak on September 2nd.
S&P/TSX	**20,166**	**20,070**	Largely flat for the quarter, index peaked on September 3rd, reversing a 3.2% gain in the final weeks.
Price of Gold (USD)	**1,769**	**1,757**	Flat for the quarter with inflation fears offset by risk off sentiment- declined from a 3% gain from September 3rd.
Currency (CAD/USD)	**0.8066**	**0.7891**	-2.2% with global concerns of Evergrande, typically the USD dollar is a safe haven for investors
10 Year Government of Canada Bond Yield	**1.39%**	**1.47%**	+5.7% move in bond yields for the quarter as the Bank of Canada reduced asset purchases from $3bln per week to $2bln per week. Market expectation is that a further reduction would be announced in its October meeting.

Source: Bloomberg

Notes:
4. https://www.cbc.ca/news/business/evergrande-deal-chinese-bond-payment-1.6185226

Canadian Election Called and Completed

On August 15, Justin Trudeau called a federal election (Canada's 44th), which took place on September 20th. Whether Covid-19 was the issue or not, voter turnout was only a bit above 60%. While Liberals managed to win the election, there continues to be a minority government with little change in seat count or structure for each of the two major political parties. Less than 20% of the adult population voted for the Liberals (vs. 33% at last count). From a macro perspective, the results of the election will have little impact on the fiscal stance - looser fiscal policy is here to stay! While there will be increased spending, due to the better revenue performance to date, the deficit for F2021/22 will not change substantially (~$157bln post election vs. $155bln pre-election). Going out further, there is no plan for a balanced budget.

Taper vs. Liftoff

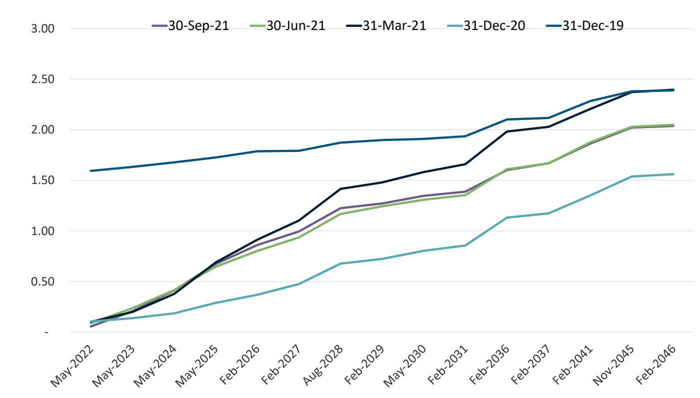
As anticipated, during the quarter, the Bank of Canada further reduced its purchases of Government of Canada securities from $3bln/week to $2bln/week. Since the federal election was underway this quarter, the Bank of Canada's meeting in September was uneventful as they remained apolitical. Governor Macklem, however, provided new information regarding the Bank's path to exiting quantitative easing – advising that while tapering continues, there will be a shift to a reinvestment phase (as bonds mature) to balance the Bank's assets. This "reinvestment" process would continue through the first interest rate increase. With the federal election now behind us, the expectation is that at the Bank of Canada's upcoming October meeting, a further reduction to $1bln/week will be announced and the reinvestment phase will start soon afterwards. The Bank of Canada's total assets are now at $493bln vs. a peak of $575bln as at March 10, 2021 and a low of $120bln prior to the start of the pandemic.

During the US Federal Reserve's September meeting, it was also mentioned that tapering would start and end before an increase in overnight interest rates. The market expects tapering to be announced in its November meeting, commencing shortly thereafter, with purchases ending by mid 2022. The market expects interest rate hikes would then begin in late 2022. Currently the Fed is buying US$80bln per month of Treasury and US$40bln of agency-backed securities (MBS) each month. The expectation is for them to announce cutbacks of US$10bln per month of Treasury and US$5bln/month of MBS.

Quarter in Review

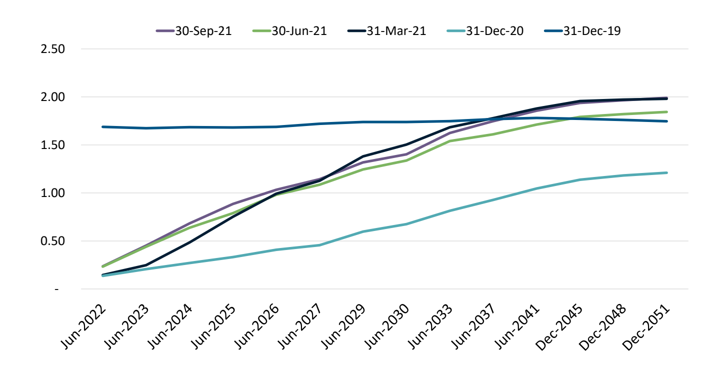
During the quarter, the Federal Reserve ("the Fed') kept interest rates unchanged at 0% (lower bound) in Q3. US interest rates for the quarter were mixed, movement of -3bps[5] to +6bps as the curve movement was almost benign.

Exhibit 2: US Yield Curve



Source: Bloomberg

Exhibit 3: Canadian Yield Curve



Source: Bloomberg

Notes:

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

The Bank of Canada kept their overnight rate unchanged in Q3 at 25bps. The Canadian yield curve was steeper for the quarter. Interest rates moved higher as much as 15bps, with the long end moving the most. The yield volatility of the 10-year Government of Canada bond picked up this quarter with a move of 35% (peak to trough) vs. last quarter of 17%.

New investment grade corporate issuance continued to be strong in the quarter in Canada at $27.6bln vs. $22.4bln in Q3/20. We continue to see corporate issuers refinance bonds early or take advantage of the all-in low interest rates. Canadian investment grade corporate spreads were mixed moving -2bps to +6bps, with 30-year bonds widening the most.

Spreads widened out very quickly during the beginning of the pandemic in March 2020 (see Exhibit 4 below), but have since narrowed by as much 190bps since peaking. We do note that since the Corporate Bond Buying Facility expired in May 2021, spreads have been pretty muted since then. Note that a 190bps change is equivalent to about an 8.5% price adjustment for a 5-year bonds.

Exhibit 4: 5-Year Investment Grade Corporate Spreads

Source: Bloomberg

Exhibit 5: Returns for Fixed Income Asset Classes

Asset class returns	Q3/21	Q3/20	YTD 2021	YTD 2020
Bond Universe Index	-1.40%	0.55%	-3.95%	8.00%
Corporate Bond Index	-1.06%	0.19%	-2.39%	6.82%
FTSE High Yield Canadian Index	0.26%	0.84%	6.20%	2.46%
S&P/TSX Preferred Index	2.76%	11.46%	17.44%	-1.07%

Outlook & Strategy

"*Be fearful when others are greedy and greedy when others are fearful*" – Warren Buffett.

The stretch for yield continued even more so this quarter as interest rates continued to move lower for the early part of the quarter. Then, as investors returned to their chairs from summer break and began to really focus on the markets, rates trekked higher into the home stretch. We continue to stay disciplined during periods when all-in yields are depressing and meagre - especially when people are toppling over others to place money into those opportunities.

The number of bonds trading above par in the Canadian Investment Grade Bond Universe was 85% at the end of Q3 vs. 88% at the end of Q2). We operate and invest in a very patient manner. With expectations of more tapering talk in Canada and the US to start their respective taper process, we believe there will be volatility that will create better opportunities to lock-in higher yields than were seen in Q3.

The Canadian Bond Universe Index now yields 1.80% vs. 1.72% (at the end of Q2), but we target a yield above that for our strategies.

We also want to take this moment to honour the first ever National Day for Truth and Reconciliation (September 30th) – Every child matters.

Take Care,
Diane Pang

Lead Manager,
Cumberland Fixed Income*
October 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.