FIXED INCOME - FOURTH QUARTER 2021

Transformers Land on Earth?

Yes, Omicron has landed, but in COVID-19 form. Just as we thought the Delta variant would be our focus, another variant emerged - Omicron. By the way, there are 12 variants that are being tracked[1] with Delta and Omicron being the two variants of concern. Due to Omicron, some countries re-imposed lockdowns and/or travel restrictions to prevent the spread of this highly transmissible new variant. By mid-December, Canada advised its citizens to curb non-essential travel – but we all know that advising and imposing a rule could end up with two very different outcomes on the path of spread of these variants of concern. Symptoms seem to be milder, but the transmission period also seems to be shorter than those of the Delta. Ontario specifically has seen a surge of new COVID-19 cases and while the percentage of hospitalizations of those who test positive is lower, just by the increased number of positive cases, this could still prove to stress our hospitals and health care system as the infection spreads. Public health units have reached their capacities.

With 77%[2] of the Canadian population now double vaccinated, the push for a booster (or third shot) is on with 7.6MM Canadians having received their 3rd dose (~20%). After 6 months of an individual's second vaccine, the efficacy starts to wane, particularly with Pfizer. Also noteworthy is the fact that the verdict on vaccine efficacy is still evolving.

Market Indicators

Markets not only reacted to the surge in COVID-19 cases this quarter, but also to the surge in inflation around the world and what central banks are going to do about it. The quarter ended up, overall positive, despite some volatility from expectations of central banks to hike interest rates earlier than originally anticipated, offset by the emergence of the new Omicron variant. Below (Exhibit 1) are some market indicators that we are following.

Exhibit 1: Market Indicators

	Sep 30, 2021	Dec 31, 2021	Comments
WTI Crude Oil (USD)	**$75.03/bbl**	**$75.40/bbl**	Flat even though OPEC and parties continue to co-operate on production levels offset by the emergence of the Omicron variant and re-imposed restrictions in some countries that fears of demand recovery could be curbed
S&P 500	**4,308**	**4,766**	+10.6% as markets continue to trek higher with the expectation that this current COVID-19 wave will be shorter
S&P/TSX	**20,070**	**21,223**	+5.7%, index peaked at 21,768 during quarter
Price of Gold (USD)	**1,757**	**1,825**	+3.9% as the Fed retracted from labelling inflation as transitory
Currency (CAD/USD)	**0.7891**	**0.7902**	Relatively flat, given oil was also flat on the quarter.
10 Year Government of Canada Bond Yield	**1.47%**	**1.42%**	-3.4% move in bond yields with Omicron fears more than offsetting the fact that the Bank of Canada started reinvestment phase. Movement in 10-year government bond yields was as much as 37% from peak to trough during the quarter.

Source: Bloomberg

Notes:
1. https://www.cdc.gov/coronavirus/2019-ncov/variants/variant-classifications.html
2. https://covid19tracker.ca/vaccinationtracker.html

US Update

Federal Reserve ("Fed") Backs off Transitory Inflation, Starts and Gains Momentum Tapering, Lift-off in View
At its November 3rd meeting, the Fed announced it would start reducing its monthly asset purchases by US$15billion/month to purchase US$105billion/month. In addition, there was a further reduction slated of US$15billion/month for December to bring purchases down to US$90billion/month.

By the end of November, in a meeting with Congress, Fed Chair Powell relented to retiring the word "transitory" to describe inflation. Inflation pressures are more persistent than originally expected and as a result, the Fed noted they would end asset purchases earlier than originally planned. As a result of the Fed's inflation pivot in its December meeting, the Fed announced that commencing January, purchases would total only US$60billion/month. At that pace of US$30/billion reduction per month, tapering could now end by the end of Q1/2022.

The Fed's overnight interest rate remained unchanged at 0% (lower bound) during the quarter. Analysts are now anticipating overnight interest rate hike as early as May 2022, with 3 increases in total by January 2023.

Powell Re-elected for Second Term
On November 22nd, President Biden announced his intent to nominate Jerome Powell to another four-year term as the Federal Reserve Chair. Jerome Powell first took office as the Chairman of the Board of Governors of the Federal Reserve System in February 2018 and his term was up for expiration by the end of February 2022. With this nomination, his term as Chair will now end in February 2026, with his term as a member of the Board of Governors expiring on January 31, 2028. Of the last five chairs, only one was not reappointed after her first term - Janet Yellen: while there was a Presidential party change during her time as Fed Chair, historically it did not matter on re-nomination.

Debt Ceiling Issue Averted Just in Time!
The debt ceiling was increased by US$2.5 trillion to US$28.9 trillion, which leaves the country enough spending power to cover its deficits post the November 2022 midterm elections. The vote was passed in the Senate (50 to 49) on the afternoon of December 14th and the House voted 221 to 209 just post-midnight on the 15th. This seamless resolution came quickly after a deal the week prior allowed it to be a simple majority vote vs. the 60 votes needed to move most legislation through the Senate. This vote was timely as the Treasury Department had warned of its inability to pay the nation's bills soon after the 15th. As a result of this increase, the expectation is an increase in Treasury bill supply in the market to replenish the Treasury's cash balance to around US$600 billion from US$134billion on December 15th (and a peak of US$1,800billion during 2020).

Canadian Update

Bank of Canada Jumps to Reinvestment Phase – Rate Hikes Not That Far Away Now
The Bank of Canada had two meetings during the quarter and they wasted no time during the first of those meetings to announce the end to tapering. By the end of Q3, the Bank of Canada had cut purchases down to $2billion/week, and the market had anticipated that the Bank would reduce it by another $1billion in its October meeting; however, they decided to jump right into reinvestment phase. Note that the Bank signaled that the reinvestment phase will continue until overnight interest rate hikes begin and then they will consider shrinking the balance sheet by letting the reinvestment end. Currently the Bank's assets are around $500billion (versus a low of $120 billion prior to the start of the pandemic). Markets are now anticipating a lift-off in the overnight interest as early as April 2022 (vs. July 2022 at the end of last quarter).

Monetary Framework Reconfirmed

On December 13th, the Minister of Finance and Bank of Canada concluded its review and renewal of the monetary policy framework that occurs every five years. The renewal confirms the Bank of Canada's commitment to using a flexible inflation target strategy (ie. targeting the 2% midpoint of a 1% to 3% inflation-control range). Inflation targeting has been part of the Bank's mandate for 30 years now and over that period had seen inflation low and stable, even during periods of external shocks (ie. 2008-2009 global financial crisis).

The framework has three elements:

1) Target is symmetric – equally concerned about inflation overshooting or undershooting the target range;
2) Monetary policy is forward-looking – typically it takes six to eight quarters for things to work its way through the economy and decisions are based on where inflation is likely to be in the future, not based on where it is today; and
3) Framework is straightforward to communicate – so everyone can understand.

During the review process, two other inflation approaches were examined: average inflation targeting (AIT) and dual mandate (targets both inflation and employment, nominal gross domestic product targeting and price-leveling targeting). AIT was less beneficial when inflation was above the target as it typically increased volatility in employment and output. The dual mandate performed similarly to the flexible inflation target approach, but affected employment only modestly even though it is a key component. It was concluded that the current flexible inflation targeting would still be more beneficial to Canadians.

Canadian Budget Update

On December 14, Finance Minister Chrystia Freeland gave a Fall Economic Statement which highlighted stronger economic growth that will actually reduce the two-year Federal deficit by $60bln (for Fiscal 2020/2021 and Fiscal 2021/2022). Government of Canada financing requirements for Fiscal 2020/2021 will now be $314.6 billion vs. the original budget of $340.6 billion. Meanwhile for Fiscal 2021/2022 federal financing requirements is $155.8 billion vs. $190.7 billion. Albeit these are still large numbers, but they are moving in the right direction!

Elsewhere Around the World

News in the Shadows - Default Declared on Evergrande Group

Evergrande Group was topical last quarter as markets seesawed with global investors worrying about the repercussions of a default of China's second largest real estate developer. What seemed to be such big noise in September kind of went silent, so to speak. On December 9th, Fitch Ratings declared Evergrande Group in default as they failed to pay two coupon payments post its grace period. This declaration could trigger cross defaults on Evergrande's other US dollar debt which amounts to about US$19.2 billion[3]. The downgrade by Fitch that day was preceded by a declaration of default on Kaisa Group Holdings, another property developer in China. Evergrande's US denominated bonds traded as low as 20 cents on the dollar. Note that foreign bondholders have different claims on assets from mainland creditors and some analysts expect the Chinese government will prioritize homeowners and mainland creditors over foreign bondholders. This story will continue to evolve, particularly as restructuring continues; however, seems like the initial concerns spilling into our domestic markets in Q3 have tempered.

First Major Central Bank Hikes Overnight Interest Rate

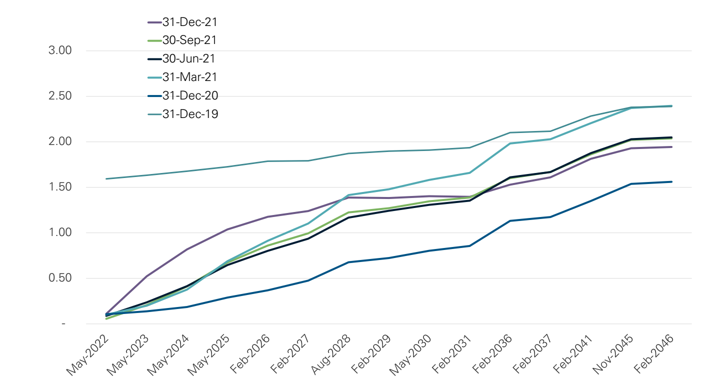
On December 16th, the Bank of England raised its overnight interest rate from 0.1% to 0.25%, being the first major central bank to raise interest rates with an overwhelming majority vote of 8 to 1 for the increase. With inflation at 5.1% and anticipating a peak of 6% by early 2022, the Bank of England felt it was prudent to hike. Unemployment rate is at 4.2% (hovered around 3.9%) before the pandemic.

Notes:
3. https://www.bloomberg.com/news/articles/2021-12-09/evergrande-defaults-for-first-time-as-china-debt-strains-spread?sref=sUhEBxbI

Quarter in Review

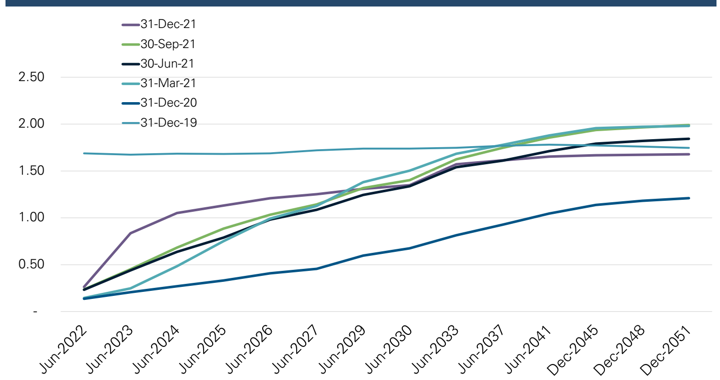
The Fed kept overnight interest rates unchanged at 0% (lower bound). US interest rates moved -9bps[4] to +41bps with the front-end interest rates reacting the most due to the anticipation of an increase to the overnight interest rate earlier than originally anticipated. The movement in the US 10-year treasury was 26% peak to trough, vs. 30% peak to trough in Q3. The bigger mover was the US 2-year Treasury, moving 184% from peak to trough with a move of almost 50bps (up from 76% in Q3).

Exhibit 2: US Yield Curve



Source: Bloomberg

Exhibit 3: Canadian Yield Curve



Source: Bloomberg

The Bank of Canada kept their overnight rate unchanged in Q4 at 25bps. The Canadian yield curve was flatter for the quarter. Interest rates moved anywhere between -31bps to +38bps, with the short-end moving the most. The yield volatility of the 10-year Government of Canada bond was still high at 37% from peak to trough vs. last quarter of 35%. Similar to the US, the 2-year Government of Canada moved aggressively at 105% from peak to trough vs. 34% last quarter.

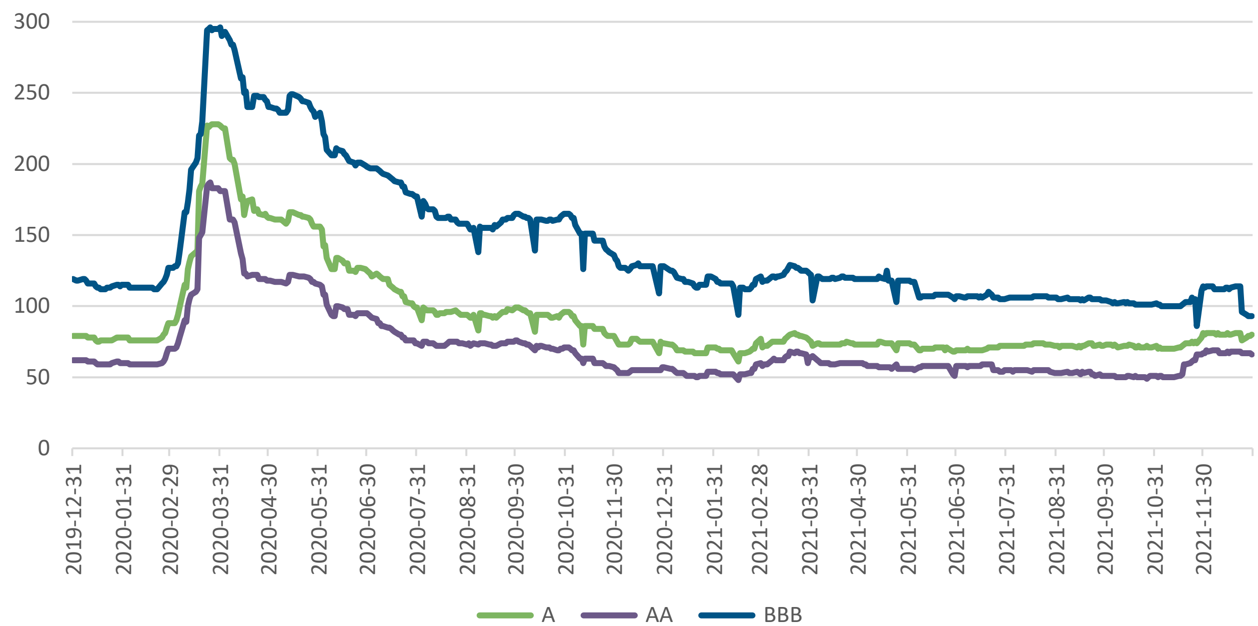
New investment grade corporate issuance continued to be strong in the quarter in Canada at $32.5 billion vs. $21.6 billion in Q4/20. We continue to see corporate issuers refinance bonds early or take advantage of the all-in low interest rates. Canadian investment grade corporate spreads were mixed moving -26bps to +15bps, with 5-year AA bonds widening the most.

Spreads widened very quickly during the beginning of the pandemic in March 2020 (see Exhibit 4 below), but have since narrowed by as much as 200bps since peaking. We do note that since the Corporate Bond Buying Facility expired in May 2021, spreads have been pretty muted. Note that a 200bps contraction in spreads is equivalent to about an 9.7% price appreciation for 5-year bonds.

Notes:
3. Bps means basis point. 1bps equivalent to 0.01%

CUMBERLAND
Private Wealth

Exhibit 4: 5-Year Investment Grade Corporate Spreads



Source: BMO Capital Markets

Exhibit 5: Returns for Fixed Income Asset Classes

Asset class returns	**Q4/21**	**Q4/20**	**2021**	**2020**
Bond Universe Index	1.47%	0.63%	-2.54%	8.68%
Corporate Bond Index	1.08%	1.80%	-1.34%	8.74%
FTSE High Yield Canadian Index	-0.02%	4.12%	6.18%	6.69%
S&P/TSX Preferred Index	1.87%	9.34%	23.75%	6.11%

CUMBERLAND
Private Wealth

Outlook & Strategy

"Nothing ever becomes real till it is experienced." -- John Keats

Who would have thought COVID-19 would still be topical almost 2 years in? While COVID-19 has become more transmissible, severity of symptoms has lessened, and as such, people are feeling more optimistic of the future. The question is now, how fast and how quickly can and will central banks increase overnight interest rates? In 2018 when the FED hiked too quickly, we saw markets react poorly. Whatever the case, central banks need to juggle the now "non-transitory" inflation vs. the rampant spread of Omicron that could slow economic recovery, all the while maximizing their goal of full employment. We all know that by the end of 2022, overnight interest rates will be higher than where they started in 2022 – how much higher will depend on COVID-19 and repercussions from it. We also know by experience that the yield curve will react and move ahead of actual rate hikes. As a result, we continue to position and look for opportunities where we can preserve capital. We are being disciplined in trying to buy shorter duration bonds at or near par. Volatility will heighten as the market struggles with balancing rising rates vs. growth concerns and with that, there will be pockets of opportunities to buy and lock-in yields as there were during Q4. Patience remains the key.

The number of bonds trading above par in the Canadian Investment Grade Bond Universe was 85% at the end of Q4 (unchanged vs. Q3) but there were pockets of buying opportunities. The Canadian Bond Universe Index now yields 1.91% vs. 1.80% (at the end of Q3).

Wishing everyone a very happy, healthy and prosperous New Year!

Take Care,
Diane Pang

Lead Manager,
Cumberland Fixed Income*
January 4, 2022

*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.