CUMBERLAND

Private Wealth

FIXED INCOME - THIRD QUARTER 2022

The drivers of fixed income valuation and thus its performance in Q3 2022 remained similar to those we spoke about for the first half of the year, resulting in a modest quarterly gain in total return. Inflation remained public enemy number 1,peaking at 9% in the US and 8% in Canada during the quarter, before receding through quarter end due primarily to declining energy prices. Both the Federal Reserve and the Bank of Canada hiked their benchmark interest rates very aggressively during the quarter in response to extended inflation concerns.

Discussion of a global recession continued with increasing prices, consumer debt burden, employment levels and supply chain issues consuming the majority of the bandwidth for slowing growth theories in several key markets.

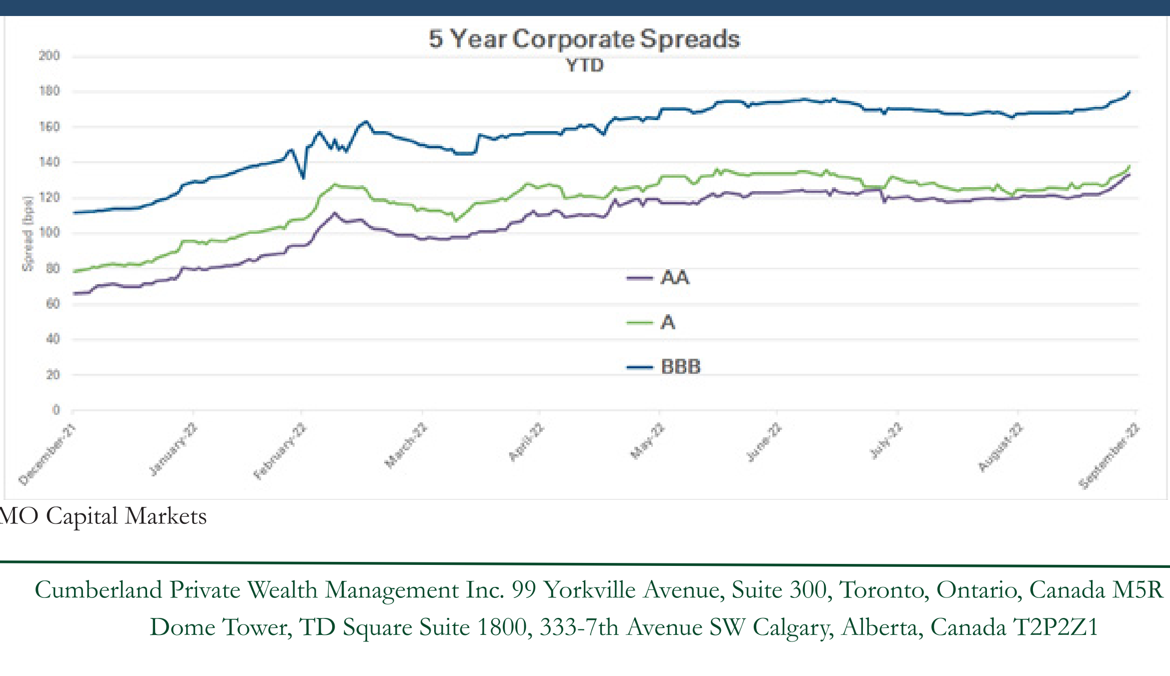
Canada Update

The Bank of Canada (the "Bank") hiked its benchmark interest rate 1% on July 13th, and another 75 bps more on September 7th. This brought the overnight interest rate to 3.25%, its highest level since 2008. Inflation continued its upward trend for most of the quarter, remaining far above the Bank's target interest rate of approximately 2%.

The Bank's September 7 statement noted: "CPI inflation eased in July to 7.6% from 8.1% because of a drop in gasoline prices. However, inflation excluding gasoline increased and data indicate a further broadening of price pressures, particularly in services. The Bank's core measures of inflation continued to move up, ranging from 5% to 5.5% in July. Surveys suggest that short-term inflation expectations remain high. The longer this continues, the greater the risk that elevated inflation becomes entrenched." With the subsequent 7.0% inflation reading for the month of August, the trend is thankfully downwards for the second month running, but again remains well in excess of the Bank's desired levels. Markets are currently anticipating a further 50-75 bps hike through to the end of 2022. The Bank's benchmark overnight interest rate is now forecast to measure almost 4%.

Corporate bond spreads widened slightly in the quarter, particularly in the final days, driven by interest rate volatility. AA credit spreads increased 10 bps (to 133bps), single A spreads 4 bps (to 138bps), and BBB spreads 6 bps (to 180bps).

5-Year Corporate Bond Spreads



Source: BMO Capital Markets

US Update

U.S. headline Consumer Price Inflation (“CPI”) reached 9.1% (year-over-year) in June. The subsequent readings in July and August trended downwards, but remain at levels (8.5%, and 8.3%, respectively) the Fed and the market view as excessive and deeply problematic. Gross Domestic Product (“GDP”) growth year over year remained positive at 1.8% in Q2 (the Q3 reading is not available yet as of this writing), but recent measurement estimates indicate a possible softening in the GDP growth trend, with the last three quarterly measurements each lower than the prior quarter. Unemployment however is a bright spot in the US economy, and while it crept up modestly in the quarter, it remains at close to historically low levels (3.7%).

The Fed, as in Canada, is rapidly tightening its interest rate policy to cool the surge in inflation powered by a return of post-lockdown consumer activity, excess savings and supply management issues. It has its work cut out for it, with increasing questions about whether they can pull off an interest rate tightening policy to reduce inflation and avoid a recession in the economy – otherwise defined as a soft landing.

Given this background, it’s not surprising the investment market currently anticipates a further 100-125 bps of overnight interest rate hikes for the remainder of 2022, and for this rate to peak at slightly less than 4.5% by the end of March 2023.

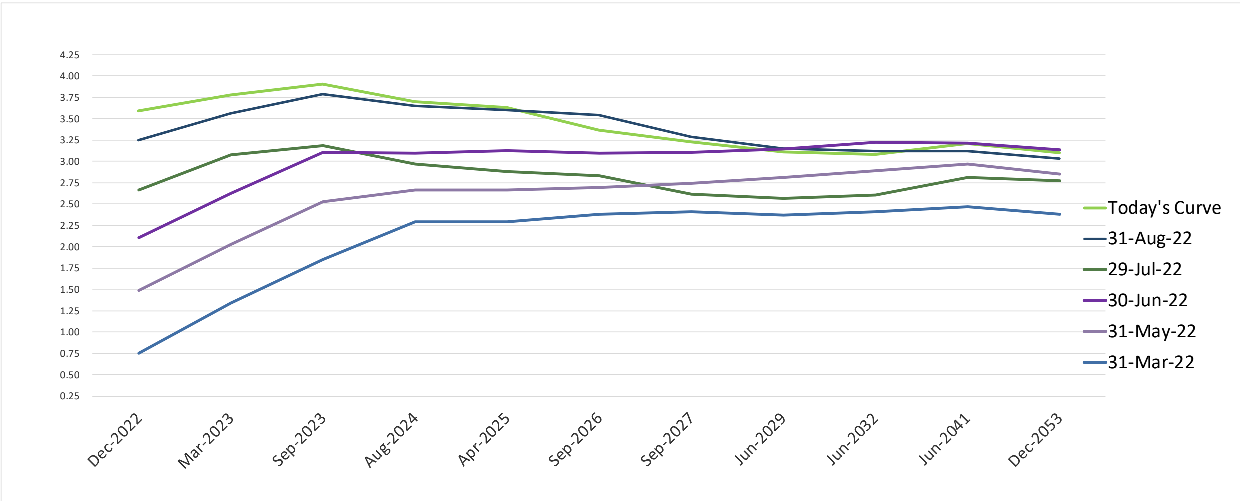
Quarter in Review

The quarter began positively, as the domestic bond market generated its first positive monthly return of the year in July. This bump in performance was driven partly by the belief that this period of interest rate hikes was perhaps closer to its end point than previously thought.

However, August and September saw a more sober assessment of recent economic data, in particular a disappointing US CPI results for the trailing period. These indicated that inflation is continuing to exceed expectations and that in the US, is not decreasing as rapidly as the Fed had previously hoped. As a result, interest rates will likely remain elevated and the trend of overnight interest rate increases will continue for a longer time period in order to quench inflation than investors and consumers had anticipated with the positive data earlier in the quarter. This data resulted in negative bond market returns over the last two months of the quarter.

The Bank instituted a 75 bps hike on September 7th. This followed the unexpectedly high 100 bps hike on July 13th. The Canadian yield curve shifted higher and progressively inverted as the quarter wore on, as shown in the chart below. Interest rates moved in wide range, from +148 bps in the shortest (3 month) maturities to -11 bps for the 30 year. The anticipation of ongoing interest rate hikes, and increasing recession fears drove this outcome. The movement in the bellwether Canada 10-year bond yield was 27% peak to trough, vs. 51% in Q2/22. Both figures are elevated changes from a historical perspective. The bigger move occurred in the 12-month yield curve, which increased 80% from peak to trough through the period, but is still down vs. the 182% increase in the last quarter.

Canadian Yield Curve



Source: Bloomberg

Interest rate volatility and wider corporate bond spreads (please refer to the Corporate Credit spreads Chart above), impacted the quarterly return for all fixed income asset classes (see table below) and made for a challenging environment to find areas of opportunity. However, the various bond indices managed to eke out a small, positive total return for the quarter. This was in sharp contrast to the historically low returns generated in the first half of 2022. Shorter duration bonds and strategies fared a little better than the broader fixed income market index returns on a YTD basis as their sensitivity to interest rate movements is lower.

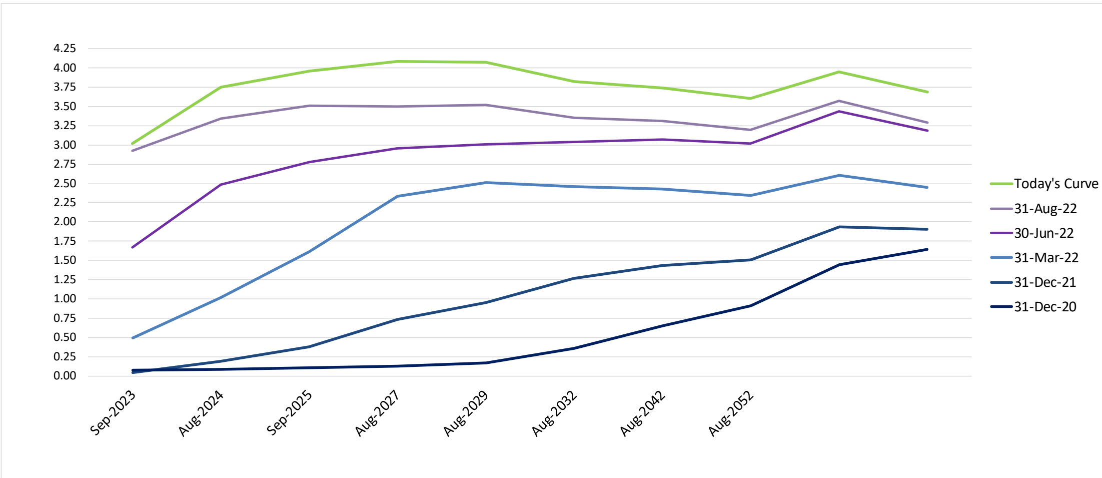
Returns for Fixed Income Asset Classes

Asset Class Returns	Q3/22	Q2/22	Q1/22	2021	2020
FTSE Canada Universe Bond Index	0.5%	-6.0%	-7.0%	-2.5%	8.7%
FTSE Canada Corporate Bond Index	0.2%	-5.1%	-6.5%	-1.3%	8.7%
FTSE Canada HY Bond Index	0.7%	-5.1%	-3.1%	6.2%	6.7%

Source: Bloomberg

In the US, the Fed hiked 75 bps most recently on September 21st, its third consecutive 75 bps hike. US Treasury yields increased anywhere from +56 bps to +122 bps, and the front end maturities moved the most due to fears of further and more aggressive Fed interest rate increases. The movement in the US 10-year Treasury yield was 80 bps peak-to-trough, and higher than last quarter's 49 bps peak to trough move. The US 3-month Treasury yield was 165 bps higher, which was the biggest mover over the quarter. Please see the chart below.

US Yield Curve



Source: Bloomberg

Outlook and Strategy

Recent positive comments from the Fed, in addition to the potential inflation peak in the past quarter, may provide some near term stability to the investment markets, although it will be a balancing act between controlling inflation, managing any recessionary signals on the horizon and other factors and forces at play globally, the war in Ukraine, the energy markets, and other macro-economic shocks such as the one the UK Government delivered a couple of weeks ago with an unrealistic budget program. There is concern that decreasing CPI figures are on the horizon and as a result, we believe interest rates will likely remain within the most recent trading band for an extended period, but we do not expect them to spike unexpectedly beyond levels we have seen this year.

Turning to the fixed income markets specifically, current bond yields have become more appealing. We see attractive opportunities for both conservative shorter- to mid-term duration government bonds and higher quality corporate bonds.

Interest rates will continue to fluctuate, and may drift moderately higher, causing some short-term decline in bond values, however we believe the current yields are more compelling than they have been in many years. As a result, we are looking for opportunities to lock in investments for the benefit of our clients over time.
Thank you for your ongoing support.

Kind regards,
Owen Morgan
Portfolio Manager
Cumberland Fixed Income*
October 3, 2022

*Cumberland Private Wealth refers to Cumberland Private Wealth Management Inc. (CPWM) and Cumberland Investment Counsel Inc. (CIC). Owen Morgan (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.