CUMBERLAND

Private Wealth

FIXED INCOME - FOURTH QUARTER 2022

During the last quarter, fixed income markets continued to wrestle with (i) inflationary data and expectations, (ii) global central banks' attempts to tame inflation through ongoing interest rate hikes and reducing money supply (iii) the elevated recessionary risk concerns for the economy, both domestically and globally.

Canada Update

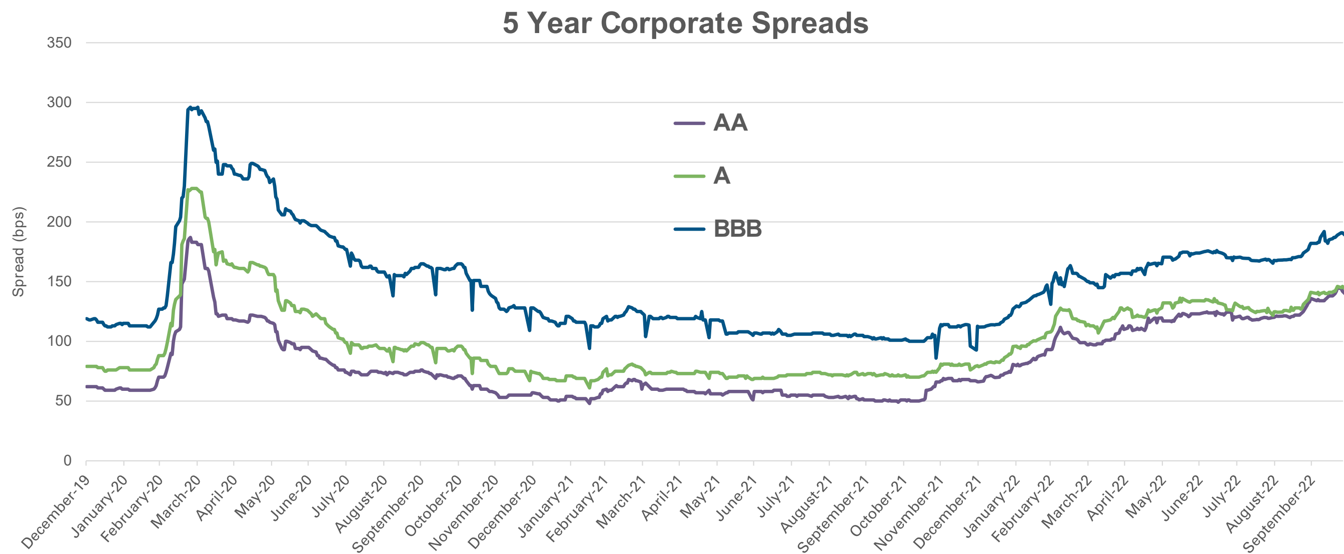
The Bank of Canada (the "Bank") continued to increase the benchmark interest rate during the last quarter. The Bank raised the rate twice by 50 bps, once in October, and again in December. This brought the overnight lending rate in Canada to 4.25%, the highest it's been since late 2008. These hikes were below the 100 bps and 75 bps increases we experienced in the summer, however, and in some part, the decreased magnitude of increase reflected the Bank's thought that the inflation rate (as measured by the Canada Consumer Price Index) was starting to move in their desired direction. But inflation, at an annualized 6.8%, though down, remains far above the Bank's target interest rate of approximately 2-3%.

The Bank's December 7, 2022 statement had two notable passages that neatly and concisely expressed the difficulties the Bank has in trying to quickly tame inflation by using interest rates hikes. First, the Bank noted that "*its Governing Council will be considering whether the policy interest rate needs to rise further*", potentially signaling to the market that the Bank's rate hike cycle is close to an end, and it may rely on market forces to continue to drive down inflation to the target levels with the embedded higher cost of funds currently established. However, The Bank also noted that "*annual run rate inflation is still too high, and short-term inflation expectations remain elevated*", leaving the door open for further interest rate hikes if inflationary forces are not curbed by the slowing economic activity and recessionary forces currently evident in the marketplace today.

The market currently anticipates a further 25 bps rate hike in the first quarter of 2023. The magnitude of the Bank's increase to the benchmark overnight interest rate will be determined by the inflation trend and the condition of the economy at the time. We anticipate that the peak for the overnight interest rate will be reached in the second quarter of 2023 and likely won't exceed 4.75%. We also anticipate a long pause by the Bank with no changes (hikes or cuts) during the second half of the year. Future movement in the interest rate, beyond 2023 will be driven by the Bank's assessment of the health of the economy and the rate of inflation relative to its target range of 2-3%.

Moving to the other variable affecting the absolute return for income investments, credit spreads, Canadian Corporate bond spreads were essentially flat for the quarter. The fact that spreads did not widen further in the quarter indicates to us that market participants did not believe that the probability of a recession increased during the quarter. Corporate credit spreads widened by 60-70 bps during 2022, however remain closer to historical norms currently, and well below the spikes we witnessed in March 2020 as we can see in the chart below.

5-Year Corporate Bond Spreads



Source: BMO Capital Markets

U.S. Update

Like Canada, the headline economic story for 2022 was inflation. U.S. annualized Consumer Price Inflation ("CPI") reached 9.1% (year-over-year) in June. The subsequent five monthly readings moved sequentially downwards, indicating to us that the Fed's tightening policies are beginning to take effect in lowering inflation. However, CPI remains at levels (7.1% in November, the most recent release) the Fed and the market view as non-sustainable and problematic.

U.S. Gross Domestic Product ("GDP") growth year over year remained positive at 1.9% in Q3, the last reading available as of this update. This was despite two consecutive negative quarterly GDP measurements in Q1 and Q2 (technically a recession occurs with two consecutive negative quarterly GDP growth results). The surprisingly strong Q3 GDP result was due to the ongoing resilience of the U.S. labour market, where unemployment remained below 4% (3.6% in Q3), and wage growth remained robust (+5.8% in November), despite the lingering fears of a recession triggered by the Fed's pace of interest rate hikes.

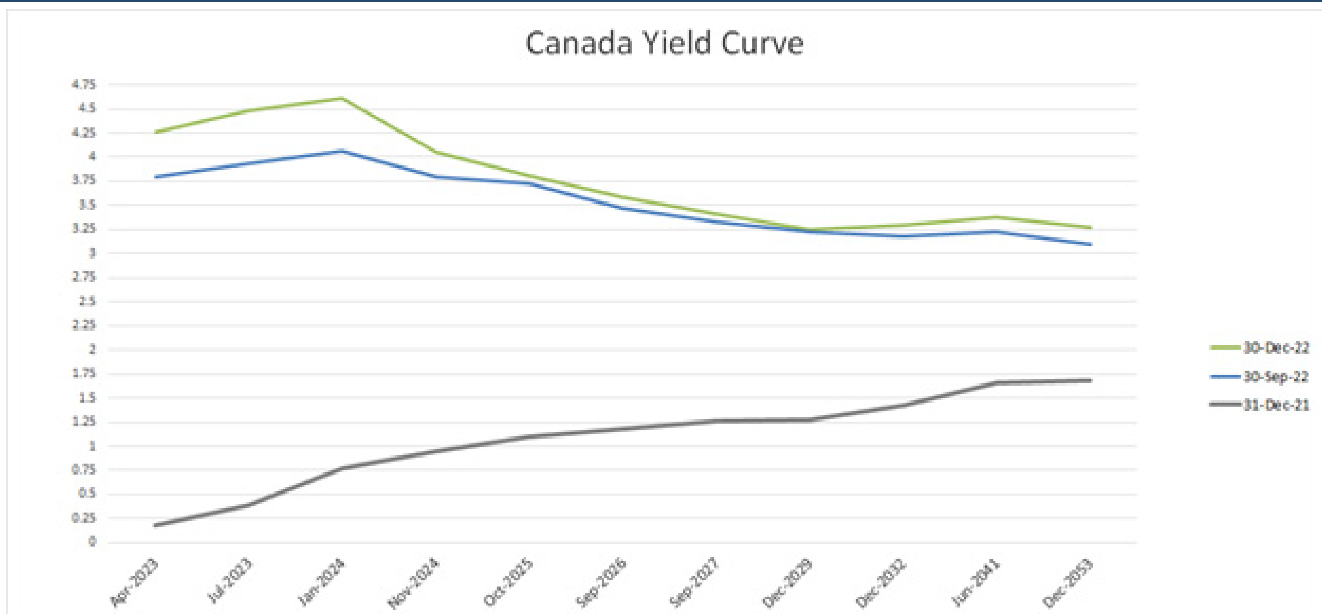
The Fed rapidly tightened its interest rate policy in 2022 to cool the surge in inflation powered by a return of post-lockdown consumer activity, excess savings and supply management issues. During Q4, it raised its benchmark Federal Funds Target Rate by 75 bps in November and another 50 bps in December. The upper bound of the Fed Funds Rate currently sits at 4.5%.

The market currently anticipates a further 50-75 bps of overnight interest rate hikes in 2023, and for the rate to peak at 5.0% in June. We anticipate, like the Canadian situation, for the Fed to pause and watch the state of the economy and pace of inflation in the second half of 2023.

Fixed Income Markets Quarter in Review

As shown in the chart below, the Canadian yield curve shifted higher and inverted moderately further during Q4. This was driven by the two interest rate hikes by the Bank, in addition to ongoing and heightened recessionary fears. Correspondingly, interest rates increased the most in the shorter maturities. The 3-12 month tenors increased by an average of +52 bps, while the mid to long-term maturities (3 years to 30 years) increased by an average of +11 bps. The movement in the bellwether Canada 10-year bond yield was 12% peak to trough, vs. 27% in Q3/22. Both figures are elevated changes from a historical perspective. The biggest move occurred in the 6-month yield curve, which increased 14% from peak to trough throughout the period, but is still down vs. the 50% increase in the last quarter.

Canadian Yield Curve



Source: Bloomberg

Despite the interest rate volatility, and in keeping with the almost flat corporate bond spreads discussed above, the quarterly returns for all fixed income asset classes were positive (see table below). This was in sharp contrast to the historically low returns generated in the first half of 2022. Shorter duration bonds and strategies generated superior returns, as their sensitivity to the increases in interest rate movements discussed above is lower. In addition, more economic-sensitive sectors (i.e. corporate issuers) outperformed the broader index, as economic conditions did not worsen as much as feared.

Returns for Fixed Income Asset Classes							
Asset Class Returns	**Q4 2022**	**Q3 2022**	**Q2 2022**	**Q1 2022**	**2022**	**2021**	**2020**
FTSE Canada Universe Bond Index	0.1%	0.5%	-5.7%	-7.0%	-11.7%	-2.5%	8.7%
FTSE Canada Corporate Bond Index	1.0%	0.2%	-4.8%	-6.4%	0.0%	-1.3%	8.7%
FTSE Canada HY Bond Index	2.1%	0.7%	-5.0%	-3.1%	-5.4%	6.2%	6.7%

Source: Bloomberg

Outlook and Strategy

Recent subtle shifts in the Bank's commentary, and the 5 consecutive months of decline in the inflation rate in both countries, lead us to feel more positive than we have in several months about the fixed income markets.

Firstly, we believe we are near the end of the rate hike cycle, and therefore the impact of higher rates on fixed income securities should soon end. As we noted in our last quarterly review, it will continue to be a balancing act between our assessment of the Bank's control on inflation trends, managing recessionary signals on the horizon and other factors and forces at play globally (the war in Ukraine, the global energy markets, and other potential macro-economic shocks). Absent any material unforeseen shocks, we believe interest rates are close to their peak, a positive for the fixed income instruments we own in our portfolios.

Secondly, there is a risk of a recession in our view, but we believe it will be mild. Consensus forecasts of Canadian and U.S. GDP expects positive growth in 2023. In addition, the labour markets in both countries remains very tight, which while not great from an inflationary perspective, is good for economic growth. Corporate spreads have widened as a result of recessionary concerns, however we believe spreads will remain resilient next year as most corporate balance sheets are in a favorable position.

Finally, given the curve inversion and that there remains a rate hike or two to go, we maintain a shorter duration than the benchmark. To expand further, some of the investment opportunities in the 2-3 year range offer yields that are almost as attractive as paper 7-10 years out, and we do not believe the relatively minor additional yield compensates us adequately for the additional maturity risk or remaining interest rate risk. However, we believe as the year progresses, this will likely begin to migrate towards a more normal, upward sloping curve, and we will look to add longer duration assets when it is prudent and profitable to do so.

To summarize, our view is that interest rates will continue to fluctuate in a relatively narrow range in the short term, and may drift moderately higher, causing some interim 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 client portfolios currently.
Thank you.

Kind regards,
Owen Morgan
Portfolio Manager
Cumberland Fixed Income*
January 5, 2023

*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.

This communication is for informational purposes only and is not intended to provide legal, accounting, tax, investment, financial or other advice and such information should not be relied upon for providing such advice. Reasonable efforts have been made to ensure that the information contained herein is accurate, complete and up to date, however, the information is subject to change without notice.

The communication may contain forward-looking statements which are not guarantees of future performance. Forward-looking statements involved inherent risk and uncertainties, so it is possible that predictions, forecasts, projections and other forward-looking statements will not be achieved. All opinions in forward-looking statements are subject to change without notice and are provided in good faith but without legal responsibility. CPWM and CIC may engage in trading strategies or hold long or short positions in any of the securities discussed in this communication and may alter such trading strategies or unwind such positions at any time without notice or liability.