

Active and Strategic Fixed Income - Short Term

Portfolio Management Team: Charles Lefebvre, Luc Bergeron, Jean-Guy Mérette, Tan Vu Nguyen and two analysts

STRATEGY OVERVIEW

Our investment philosophy relies on a multi-strategy approach whereby duration management, portfolio positioning on the yield curve, sector selection, and the active management of corporate bonds all constitute opportunities for adding value versus the benchmark. Our corporate bond approach is conservative and focuses on high quality securities.

The objective is to outperform the benchmark, to a reasonable extent, at every stage of the credit cycle. Long-term returns are therefore generated through a combination of interest income and a moderate capital gain.

QUARTERLY COMMENTARY

In the fourth quarter of 2022, oil price weakness contributed to the lower rate of inflation. Even so, core inflation remained a concern. As a result, the Bank of Canada raised its key rate again, to 4.25%. It is determined to keep interest rates high until inflation returns to its target range of 1% to 3%. Around the world, rate hikes have clouded the economic outlook. A number of countries have already slipped into recession. Global demand and growth will be affected in the coming quarters. In Canada, mortgage borrowers have already been hit hard and the real estate market has slowed.

Investors now expect Canada's key rate to peak at 4.50% in 2023. As a result, short-term bond yields rose slightly in the fourth quarter, with the yield on the 3-year Canada bond going from 3.72% to 3.80%.

During the quarter, we kept the duration slightly longer than that of the index, a decision that detracted from the portfolio's return.

The segment of the curve from 2 to 10 years is now inverted by 74 basis points (bps). At the end of September, the slope was negative by 62 bps. During the fourth quarter, the segment from 2 to 5 years inverted by 17 bps. We kept a portion of the portfolio in bonds maturing in more than 5 years. This decision was beneficial because the inversion of the curve was less significant in longer maturities.

Spreads for corporate securities with maturities of 5 and 10 years narrowed by 12 bps. Provincial bond spreads narrowed by 6 bps for 5-year bonds and by 3 bps for 10-year bonds. As for municipal spreads, they rose from 95 to 100 bps in relation to Quebec bonds. We increased our corporate holdings to a slightly overweight position. Our corporate overweight contributed to the return while our provincial underweight detracted slightly.

The yield curve continued to invert in the fourth quarter amid more signs of an economic slowdown. Even though the job market remained strong, we expect the unemployment rate to rise. Given our economic outlook and the high level of interest rates, we will keep the duration longer than that of the index. In anticipation of an economic slowdown, we will take a selective approach to corporate bonds and we will underweight provincial bonds.