iA Clarington 2022 Mid-Year Review

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IA Clarington Bond GIF
IA Clarington Money Market Fund
IA Clarington Money Market GIF
IA Wealth Core Bond Pool

What was your outlook in January?

Heading into 2022 we expected the U.S. and Canadian economies to deliver above-trend growth for the year, with broad support from consumers, businesses and government. We believed labour demand would remain strong, further lowering the unemployment rate and boosting wage growth. Consequently, we anticipated that the preconditions for liftoff in the next Federal Reserve ("Fed") hiking cycle – an inflation overshoot and maximum employment – would eventually be met and that asset purchases would be completed by the middle of the year.

In Canada, the central bank was already indicating its discomfort with the inflation building since the beginning of 2021, and as a result it ended its bond buying program in October of last year. We projected the Bank of Canada would begin to raise its overnight rate in Q2 of this year while the Fed would start in Q3.

Since we believed bond yields would increase in 2022, even if not in a straight line, we favoured a shorter duration in our portfolios compared to our benchmarks. We viewed 10-year bond yields breaking above 2% in 2022 and ending the year around 2–2.25% in both the U.S. and Canada. We also anticipated that yield curves would flatten, as is typical at the beginning of a hiking cycle, with much of the initial bond market reaction taking place in the shorter end.

We expected corporate bonds to perform well on a relative basis in 2022 since the search for yield was alive and well in investors' minds. Supporting our view on corporates were projections for above-trend economic growth and the better protection offered by higher-yielding instruments in a rising rate environment.

We maintained our favourable view of ESG[1] bonds, believing they could generate good returns in 2022. We also noted our intention to actively participate in the new-issue market for these bonds.

We started the year with a shorter duration versus our benchmarks and noted our intention to continue expressing this bias through intermediate-maturity bonds. But we remained nimble in our management of duration via Canadian, U.S. and other interest rate markets.

We also had exposure to various U.S. credit products, such as corporate securities with a maturity of less than five years and high-yield corporate bonds. The aim was to benefit from their excess return potential and the depth and diversity of issuers in those markets compared to the Canadian corporate bond market.

Finally, we overweighted Province of Quebec non-rated municipal bonds throughout 2022 as they provide a good carry and have low interest rate risk.

What has transpired so far this year?

We started the year still stumbling out of the pandemic's grip on society, only to witness a resumption of lockdowns in China. As a result, lockdown-related supply chain issues that emerged in the latter half of 2021 persisted through the first couple of quarters in 2022, albeit to a declining degree as most countries began to open up more and reduce restrictions.

Russia's invasion of Ukraine in late February triggered wide-ranging sanctions, further impeding the flow of goods as international businesses were compelled to shutter operations in Russia and bans were imposed on imports and exports.

As we entered 2022, it quickly became clear that inflation was a much bigger and longer-lasting problem than central bank policymakers had anticipated. Reaching levels not seen in decades, inflation approached double digits and spurred central banks across the globe into action. The Fed and Bank of Canada both implemented interest rate increases of 75 basis points (bps) – along with tangible moves towards quantitative tightening – in an increasingly aggressive effort to get inflation under control. In Europe, the central bank has indicated that it will begin raising rates this summer.

Bond yields and market volatility skyrocketed in anticipation of reduced monetary accommodation, with investors testing the resolve of central bankers in their fight against inflation. Daily yield fluctuations of 10 to 20 bps across the curve are now commonplace as investors grapple with the plethora of issues facing the capital markets, the latest being a growing concern about a hard landing for the global economy as the perils of inflation spread. Following from this, the yield curve became its own story in 2022, with all sorts of inversions in Canada and the U.S. – signalling to some observers the onset of a recession in North America.

With much of the heavy lifting already done by the bond markets to raise yields above 3%, we increased duration starting in April, in line with our goal of nimbly adapting to changing market conditions. We will likely remain modestly long duration for the remainder of the year, albeit with the flexibility to respond to rapid market shifts.

We reduced our exposure to corporate credit as growing concerns about a recession and a heavy new-issue supply calendar in the early part of the year – itself a function of expectations for higher rates – placed meaningful pressure on spreads. We exited positions in high yield and lowered our weighting in Canadian investment grade corporates.

What is your outlook for the remainder of the year?

We believe there remains potential for more modest upward pressure on yields but expect that most of the damage has already been done. Nonetheless, we anticipate that elevated levels of volatility will persist as investors continually test the resolve of central bankers to tackle inflation and at the same time avoid a hard landing for the economy.

The yield curve will likely remain on the flatter side until the central banks start to blink or the short end rallies on fears of a recession.

We expect spreads to continue widening on the back of accelerated central bank rate hikes and the prospect of weakening margins from high inflation and/or slowing economic conditions.

Regarding inflation itself, we expect elevated levels through the summer before they hopefully begin to abate modestly heading into the fall.

Unfortunately, the war in Ukraine will likely remain an issue for the foreseeable future since neither side appears willing to engage in meaningful dialogue as the test of wills and supplies continues.

Against this backdrop, we will make tactical portfolio adjustments to maximize return potential. We will selectively employ duration on the long side while staying nimble to take advantage of the incredibly high volatility in the bond market. We will opportunistically trade outsized spread movements in the provincial bond market but further reduce our exposure to Canadian investment grade corporates.

As at June 23, 2022.

[1] ESG refers to environmental, social and governance factors used in the selection of investments.

For definitions of technical terms, visit iaclarington.com/glossary or speak with your financial advisor.

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