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Quarterly Update

Every quarter we are reminded how quickly information travels in today's age. As one issue resolves itself, another one appears. So far, this quarter, we have seen the labour market begin to soften, a slowdown of consumer spending, central banks determining if the rate hike cycle has done its job, and a new geopolitical issue between Israel and Palestine. This has resulted in market swings in both directions of about 10% over the last three months. The world has become increasingly more challenging for consumers in light of high interest rates and persistent inflation. While it may seem like doom and gloom, we believe we are getting closer to better times ahead.

Is the Bank of Canada done tightening?

The Bank of Canada's (BoC) governing council is divided on whether additional interest rate hikes would be required to restore price stability. While some central bank officials continue to see the potential need for further rate hikes to bring inflation sustainably back to target, others view the current 5.0% policy rate as "sufficient" to achieve that objective if held at such a level for long enough. The split among policymakers highlights the challenges the central bank is confronting amid conflicting economic signals. While headline inflation has fallen significantly in recent quarters, it remains above the BoC's 2.0% target. Economic growth has stalled in recent months, a sign that higher interest rates are having their intended effect on economic activity. Consumer spending has also continued to soften as cost-of-living pressures have been weighing on discretionary spending. In the meantime, policymakers remain in a holding pattern, awaiting additional economic data to provide insight into the trajectory of the economy and inflation in their assessment of the appropriate path for monetary policy.

After hiking interest rates in July to a 22-year high of 5%, the Bank of Canada has opted to hold the benchmark rate steady at this level following their policy meetings in September and October, though policymakers continue to reiterate their guidance that they are prepared to raise rates further if warranted. From a fixed income perspective, the prospect of a prolonged period of higher short-term rates has led many investors to increasingly favour cash and ultra-short term bond investments (e.g., money-market funds and high interest savings accounts). While cash-like investments have a role to play

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in portfolios — for instance, managing short-term liquidity and cash flow needs — we believe investors with a longer time horizon should take advantage of the broad upward repricing in bond yields by reallocating some of their excess cash-like holdings into bonds with longer maturities.

Historically, bond yields have typically peaked around the time when the BoC has reached a peak in its rate-hiking campaign. Excluding the latest cycle, we have had seven BoC rate hike cycles since 1994. On average, what we find is that long-term government bond yields tend to peak out around two months before the last rate hike of the cycle, essentially cresting within a range of five months before or concurrent with the last hike. In anticipating a cyclical peak in bond yields, one needs to be reasonably confident that we are in this plus-or-minus four-month window of the last rate hike. Markets believe the BoC is finished with rate hikes and expect rates to held at current levels through the first half of 2024. Ongoing disinflation, mounting signs of moderating economic activity in recent months and a softening labour market have broadly strengthened the expectation that we are reaching or at the end of the BoC's tightening cycle.

Think about reinvestment risk

For the first time in many years, cash is once again a useful asset class. Yet all investments carry risk, even cash. When it comes to bonds versus cash, reinvestment risk is a prominent one to consider. Reinvestment risk is the possibility that an investor will not be able to reinvest cash flows — such as matured principals and coupon payments from securities — at a rate equal to the initial investment. As interest rates eventually crest and start to decline, investors with short-term bonds would face the prospect of having to persistently reinvest cash flows at progressively lower yields.

Cash and ultra-short-term bonds have been among the best-performing fixed income segments over the past 18 months, but investors should be mindful that short duration's relative outperformance is unlikely to last. While there is considerable uncertainty about when the BoC could start to pivot from tightening to easing, history shows that longer duration bonds can generate considerable excess returns versus cash. As well, their short-duration counterparts during these plateaus between monetary policy shifts are relatively stable. Moreover, this pattern of outperformance has typically continued when interest rates begin to fall from the cyclical peak.

Given the recent string of weaker-than-expected domestic economic data has bolstered the probability that the BoC's rate hike cycle is coming to an end, we believe investors should increasingly focus on managing reinvestment risk. Extending duration can help reduce reinvestment risk, though we think it is prudent to lean into duration methodically, with consideration for one's volatility tolerance.

What are we doing?

In the midst of all of the bearishness of the market over the last three months, we've used that as an opportunity to continue to round out our portfolio in both fixed income and equity. Because we believe we are nearing the end of the rate hike cycle, we extended term on high quality corporate bonds in order to lock in higher rates for longer. Overall, this past year, we have increased our fixed income allocation and duration to levels we haven't had for close to 10 years. On the equity front, with the market volatility, we used it as a good opportunity to use up some of the cash holdings in our portfolio and re-allocate to equity names that have experience a short-term price decline that we believe will continue to grow and compound earnings for years. We still have an above-average cash balance in our model that we are continuing to hold for flexibility, and will look to re-distribute into equity names when the moment fits.

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