Fixed Income Update
Navigating a sea of volatility in fixed income

Written by

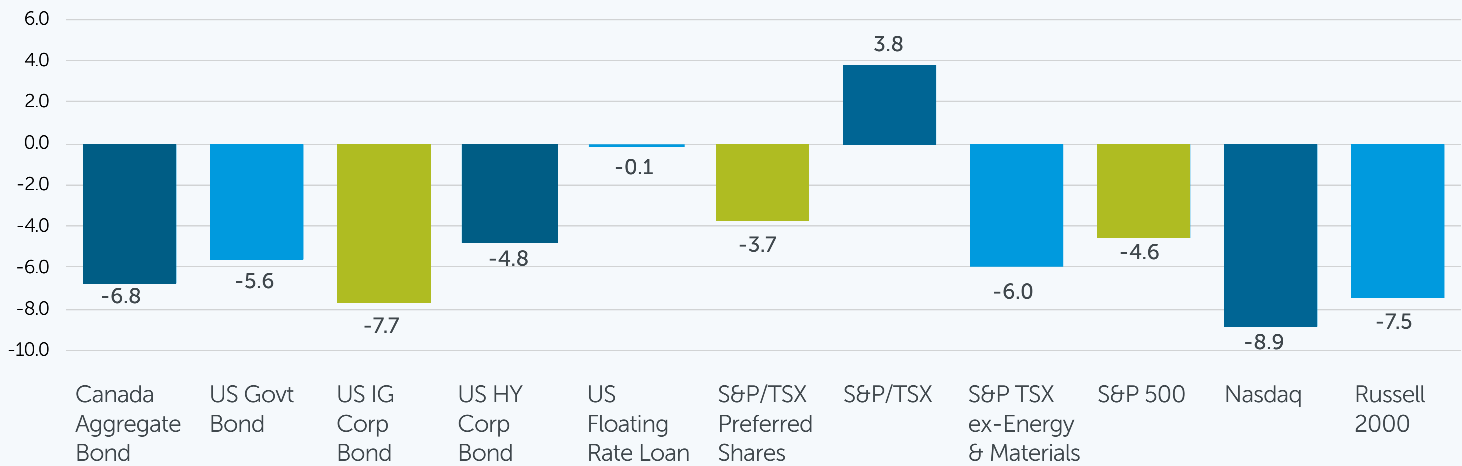
ALBERT NGO, MFE
Senior Portfolio Manager,
Fixed Income

IAN FUNG, CFA
Portfolio Manager,
Fixed Income

Q1 2022 was the most volatile quarter for fixed income markets in over 40 years and a challenging start of year for almost all markets.

Although it's only been three months since we discussed the importance of positioning fixed income portfolios to mitigate the risk of rising interest rates[1], we thought it would be appropriate to update you given Q1 2022 was the most volatile quarter for fixed income since 1980. To be fair, when we look across a spectrum of asset classes, other than energy and floating rate loans, there was really nowhere for investors to hide (U.S. equity markets had the third worst start of the year in over 20 years ahead of only the financial crisis and COVID-19 pandemic).

Q1 2022 Returns by Asset Class (%)



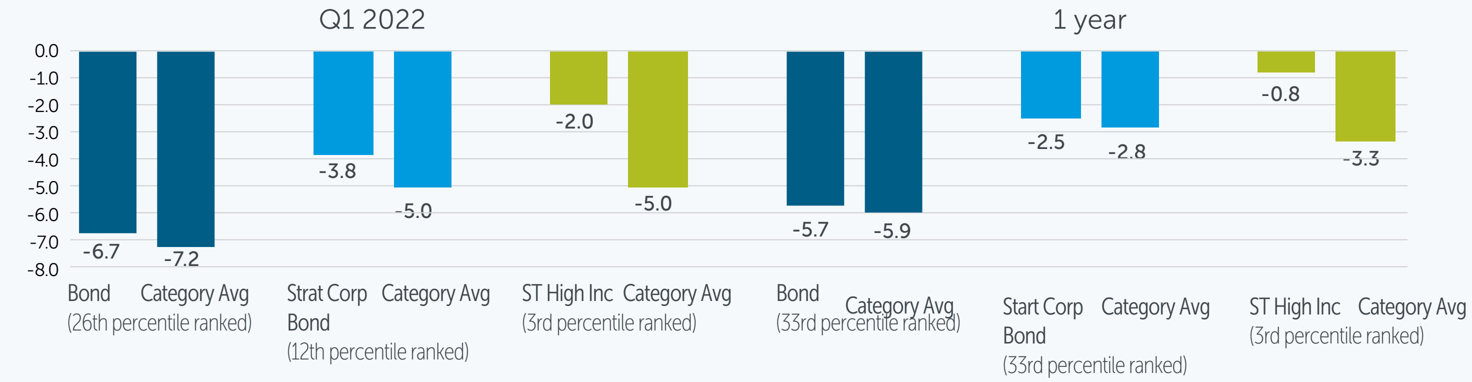
Source: Bloomberg as at March 31, 2022

For months now, we have been implementing the various strategies we previously discussed in our fixed income portfolios by reducing overall duration, maintaining overweight positions in the front-end of yield curves and increasing exposure to lower duration and floating rate corporate bonds. This positioning helped mitigate the impacts of the selloff in bonds and especially the relative weakness of longer dated bonds. Although our fixed income funds generated negative returns in what was a very challenging quarter, our positioning helped preserve capital relative to our peers, and we delivered either first quartile, or just shy of first quartile performance for the quarter and on a trailing 1-year basis.

[1] A Dynamic Fixed-Income Asset Allocation Strategy for the Post-COVID Era - January 2022

Empire Life

Q1 2022 Empire Life Fixed Income Fund Returns vs Category Averages (%)



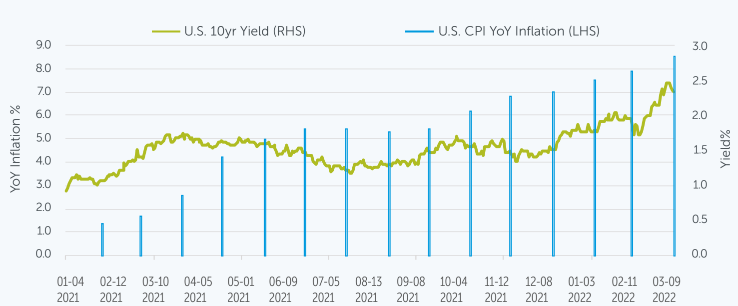
Source: Empire Life and Morningstar Research Inc., as at March 31, 2022

Persistent inflation has been the main driver of fixed income market volatility

So what caused the worst start of the year for fixed income performance in 40 years? Simply stated, the primary driver has been persistent and elevated inflation not seen since the early 1980's. The drivers of this extended period of inflation include: unprecedented monetary and fiscal stimulus; a spike in demand for goods as consumers switched from spending services; while at the exact same time, supply was reduced due to supply chain disruptions; and elevated commodity prices. Events of early 2022 are adding further inflationary pressure as the Russia-Ukraine conflict has contributed to already high commodity prices while recent lockdowns in Shanghai, China will likely extend and exacerbate supply chain issues. In addition, we are seeing increases in rent, shelter and wages, which tend to be more structural in nature.

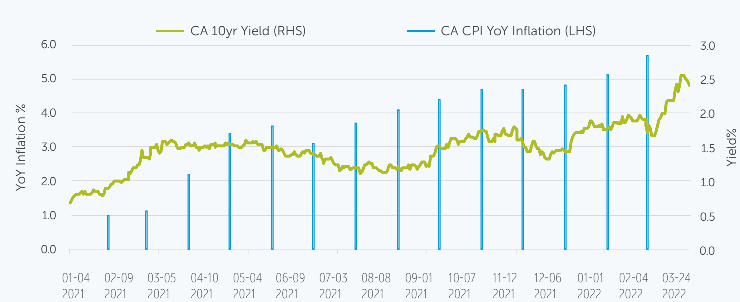
As a result of this persistent inflation well above the 2% target for central banks such as the U.S. Federal Reserve (the "Fed") and the Bank of Canada ("BoC"), central banks have become increasingly hawkish and focused on combating inflation. Last quarter, the Fed and BoC both raised interest rates at their respective meetings for the first time since the pandemic and laid the groundwork for the tightening of monetary policy via a combination of quantitative tightening and additional rate hikes. Additionally, the Fed has hinted at larger hikes, potentially hiking as much as 50 basis points (or "bps" instead of the typical 25 bps) and have stated a willingness to tighten policy beyond the neutral rate while, the BoC recently hiked the overnight rate in Canada by 50 bps. As a result of this central bank hawkishness, interest rates and bond yields have risen and have led to negative fixed income returns as higher rates equate to lower mark-to-market bond prices.

U.S. YoY Inflation and 10-year Treasury yields (%)



Source: Bloomberg as at March 31, 2022

Canada YOY Inflation and 10-year Govt bond yield (%)

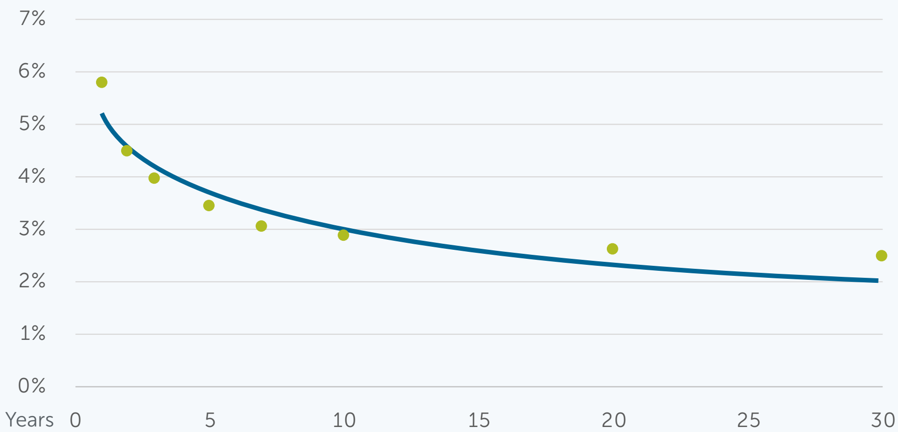


Our outlook for inflation is that it will be likely persistent but not permanent, although the exact timing is unpredictable

In the shorter-to-medium-term, some of the aforementioned drivers of inflation have already begun to abate: monetary and fiscal stimulus have and will continue to be reduced; demand for durable goods such as autos, appliances and computers have already fallen as consumers shift consumption to services; and high prices result in demand destruction and reduced consumer confidence. Meanwhile, other inflation drivers will take time: supply chain bottlenecks take time to resolve; and commodity prices, rent and wages are inherently cyclical and go through boom and bust cycles. Longer term, forces that have exerted downward pressure on inflation in the past such as an aging population and technology are still in play.

In short, we do not believe inflation will remain at these elevated levels in the long-term. And although market expectations are never a perfect predictor of future outcomes, they at least provide a rough guide for the potential easing of inflation going forward.

Expected U.S. Inflation Curve as of March 31, 2022



Source: Bloomberg as at March 31, 2022

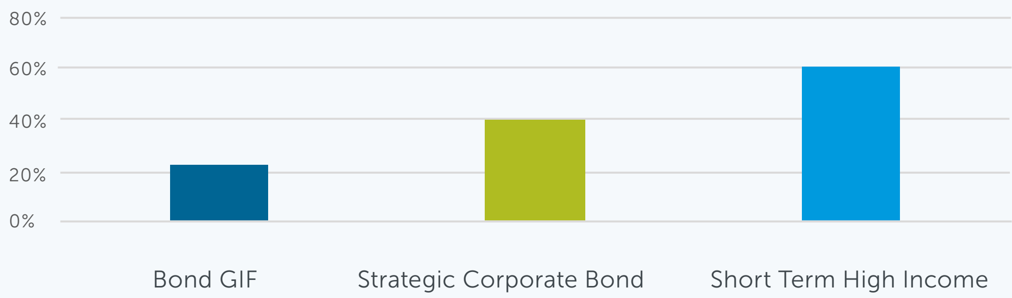
Expected Inflation = U.S. Treasury Yields - U.S. Treasury Inflation-Protected Securities (TIPS) Yields

The impact of inflation, our outlook for fixed income, how we are positioning and the importance of fixed income

Regardless of the medium to long-term outlook for inflation, upcoming economic data releases, central banker speeches and central bank policy will likely dominate interest rate and bond price moves in the short to medium-term and cause heightened volatility for fixed income investing. Despite this, it is important to remember that the inflation headwind for fixed income is likely not permanent and markets never move in a straight line, which will present long-term investors with new opportunities.

Interest rate volatility has, and will continue to lead to lower bond prices and higher yields, which increases the total return opportunity for fixed income investors deploying new capital. Already, we are seeing some of the highest yields on short-term high-quality corporate bonds since the financial crisis (~3% yield for investment grade corporates and ~5% for BB-rated corporates). As a reminder, almost all corporate bonds mature at 100 cents on the dollar (historical annual default rates for investment grade corporate bonds and high yield corporate bonds have been less than 1% and 4% respectively). In the short-to-medium term, we can deploy both new capital and proceeds from bonds that we own that either mature or are redeemed into these higher yielding opportunities.

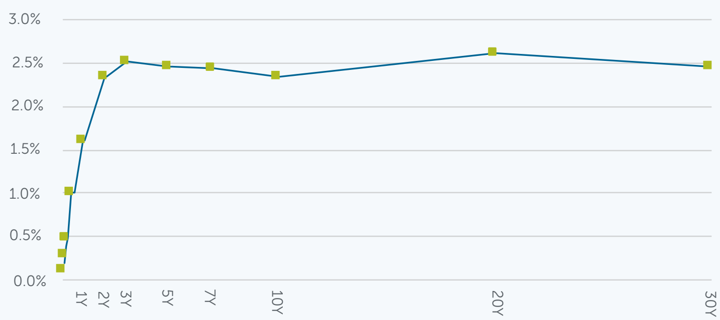
% of Empire Fixed Income Funds Expected to Mature or Be Redeemed within 2 years



Source: Empire Life Investments as at March 31, 2022

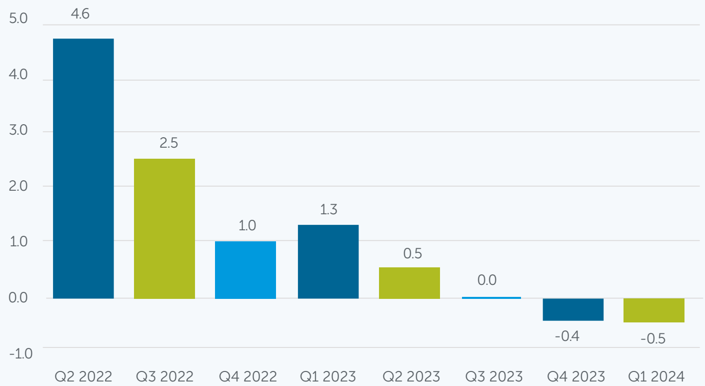
When we look at the longer-term, we are confident in the ultimate recovery value of our fixed income investments including our longer-term bonds. In addition, we are seeing various data points that suggest interest rates are unlikely to increase longer-term. When we look at yield curves and central bank hiking expectations, we see an environment that is supportive for fixed income in the longer term. Various segments of the yield curve are inverted and the market is pricing-in rate cuts in late 2023 potentially due to a combination of: declining inflation expectations; concerns of an economic slowdown; and/or central banks potentially tightening too aggressively in the short-term.

U.S. Treasury Yield Curve as of March 31, 2022



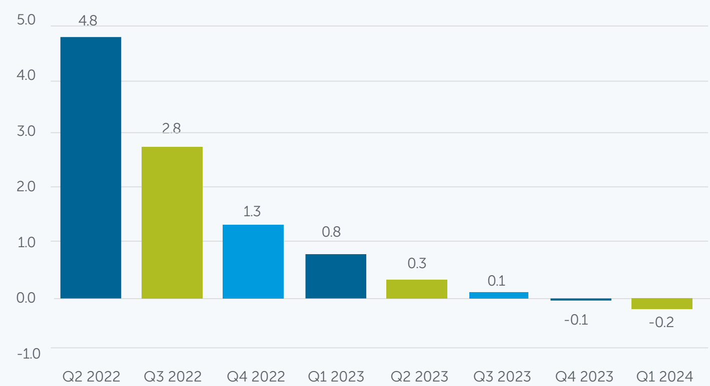
Source: Bloomberg as at March 31, 2022

U.S. Fed 25 bps Hikes/Cuts Priced per Quarter



Source: Bloomberg as at March 31, 2022

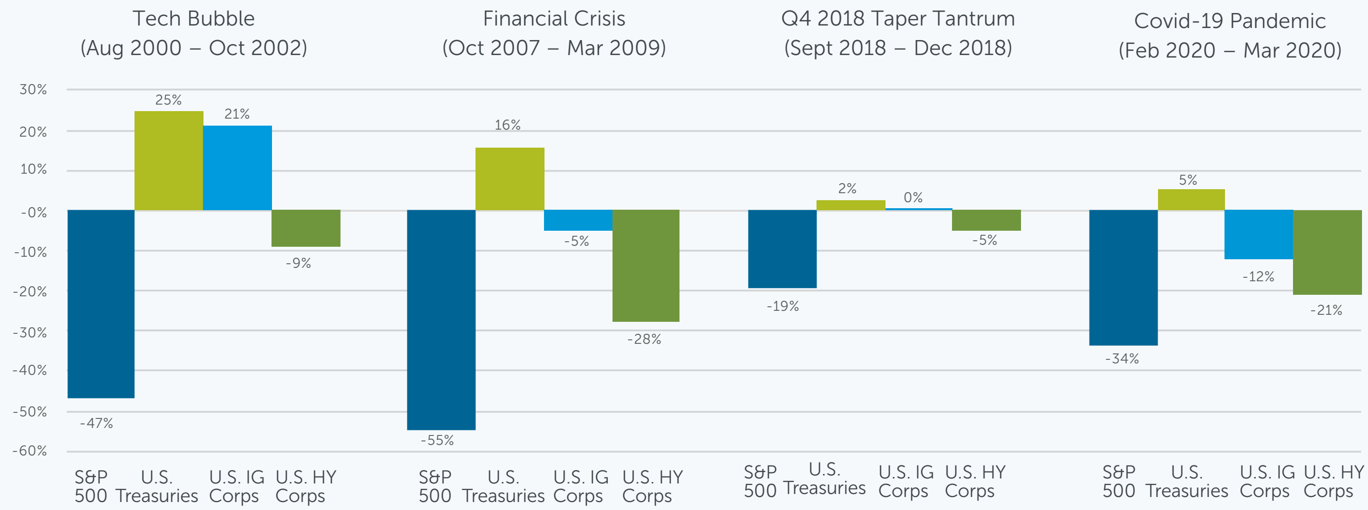
Bank of Canada 25 bps Hikes/Cuts Priced per Quarter



Source: Bloomberg as at March 31, 2022

As a reminder of the importance of fixed income, recall that fixed income can preserve capital both on an absolute and relative basis to an investor's equity holdings during market dislocations and unexpected risk events.

U.S. Equity and Fixed Income Returns During Equity Market Volatility



Source: Bloomberg as at March 31, 2022

Finally, to summarize everything above, fixed income markets will remain volatile in the short-to-medium term. During this period we will continue to deploy proceeds into some of the highest yields for higher quality short-term bonds we have seen in more than a decade to dampen volatility and pick-up yield. Longer-term, we remain confident in the ultimate recovery value of our longer-dated holdings and we (as well as inverted yield curves) see inflation and rising rates slowing and eventually declining, which will represent a tailwind for fixed income and an inflection point to invest in longer-dated bonds. In addition, inverted yield curves could be signaling a slowing economy, which have historically resulted in fixed income outperforming volatile equity markets. Unfortunately, timing exactly when the inflection point for fixed income will occur or when there will be equity market volatility is impossible and thus we reiterate the importance of fixed income for long-term investors.

Please visit us at empire.ca/fixedincome to learn more about Empire Life's fixed income products.

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The Empire Life Insurance Company
259 King Street East, Kingston, ON K7L 3A8

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empire.ca info@empire.ca 1 877 548-1881

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