Macro Talking Points

Fixed Income Insights

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In brief

- **Canada is a sweet spot in global fixed income**
- **Client questions from my trip to the Canadian west coast**
- **Rate volatility and US elections**

Goldilocks' porridge is sweetened with plenty of maple syrup. Global fixed income is enjoying Goldilocks market conditions around the globe, but nowhere is that truer than in Canada. This is because the Bank of Canada has taken the lead in the policy easing race, delivering a 50 basis point rate cut last week, cutting its policy rate by a cumulative 125 bps so far, more than any other major central bank. Talking to our Canada fixed income portfolio manager, Soami Kohly, there is likely still plenty of room to go, which is supportive of local fixed income. In his view, there is a good chance that the BoC may deliver another 50 bp rate cut at the next policy meeting in December. More importantly, the key consideration going forward is where the BoC will ultimately pause. The terminal rate may be lower than currently priced in, another bullish factor for fixed income. With that in mind, Soami's high-conviction call at this juncture is curve steepening. The CAD 2s-10s currently stands at 16 bps, but we believe that there is a lot more upside given the aggressive policy bias on the part of the BoC.[1] Separately, the Canadian credit valuation backdrop remains attractive, especially when compared with the US. Specifically, Canada IG Corporate spreads currently stand at 110 bps, against 84 bps for the US.[2] When looking at the valuation of break-even spreads, *i.e.* spreads per unit of duration, the picture is even more favorable, with BE spreads for Canada IG standing at 20 bps against 12 bps for US IG.[3] Likewise, when estimating the spread per unit of excess return volatility, one of the favored valuation indicators by our quant team, the valuation analysis points to Canadian credit being cheaper. Overall, we remain of the view that Canada is the epicenter of Goldilocks conditions for fixed income.

Where the sea meets the mountains. I was lucky enough to spend a few days last week in one of the most beautiful cities in the world in my view, Vancouver, British Columbia. Here is a quick summary of what the clients wanted to talk about. First and foremost, the US election: who is going to win, what will be the impact on global markets, on sectors, on rates, on geopolitics and the longer-term impact on the US fiscal position? Monetary policy was also a major topic, including what is priced in on curves, both in Canada and in the US. Moving on to fixed income, the client discussions gravitated around the following themes: the view on duration, the case for going global away from home bias, the decision to hedge or not hedge foreign exposures, the various components of total return in fixed income and the major drivers and a discussion of fixed income opportunities around the globe. The case for passive in fixed income was brought up as a client question. Finally, on private assets, the discussion revolved around rightsizing the allocation to private debt.

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US elections and rate volatility. We have all heard that, historically, US elections have not really mattered for markets or the macro backdrop. That is true. Except that this time may be different. There is a risk that rate volatility may rise further because of the US election. Why? It is all about initial conditions. We are entering the last stretch of the election campaign with a US economy that is doing particularly well. Some might even say too well, given that recent macro performance does not appear to be sustainable. In the event of a Republican sweep, and if the policy agenda looks like what has already been announced, we think there is a clear risk of the US economy tipping back into a higher inflation regime by adding fuel to the inflation fire through supply shocks, higher tariffs and demand stimulus. Against this backdrop, it is quite possible that rate volatility — which is already quite high — may pick up even further. Near term, duration management may be quite challenging. The good news for fixed income comes from the other side of the equation: The credit risk landscape remains relatively favorable, and credit spreads appear to be well behaved.

Endnotes

[1] Source: Bloomberg, difference between the 2-year Canada government bond yield and the 10-year Canada government bond yield. Data as of 24 October 2024.

[2] Source: Bloomberg. Bloomberg Canada IG Corp index. US IG = Bloomberg US IG Corp index. Spreads = option-adjusted spreads. Data as of 24 October 2024.

[3] Source: Bloomberg. Break-even spreads = spreads / duration. Data as of 24 October 2024.

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