TD Global Investment Solutions

Monthly Snapshot 10 minutes

Fixed Income Market Update
Monthly Snapshot

2023 JUN

At a Glance

1. The Bank of Canada ("BoC") raised its target for the overnight rate to 4.75% at its last meeting.
2. The Canadian economy received a big helping hand from consumption, which vaulted higher by nearly 6% quarter over quarter (q/q).
3. The BoC's core inflation metrics decelerated, but to a lesser degree than the headline figure, averaging 3.9% y/y in May, versus 4.3% y/y in April.

Fixed Income Outlook

The Bank of Canada ("BoC") raised its target overnight rate to 4.75% at its last meeting, stating that it will continue with quantitative tightening.

The data suggest that monetary policy has yet to exert enough of a braking force on the economy and inflation. Financial markets have further cemented expectations for an additional BoC interest rate hike this summer, leading the Canada 2-year yield to establish a new cycle high.

In the first quarter, the Canadian economy received a big helping hand from consumption, housing consumption specifically vaulted higher by nearly 6% quarter over quarter (q/q). Passenger car sales surged, as rising auto production fed pent-up demand for cars. In past research, several expenditure categories identified by the BoC as being sensitive to interest rates (like furniture, transportation services, food beverage/accommodation services, and communications spending) had solid performances.

In March, gross domestic product (GDP) growth was flat, however second quarter GDP growth is tracking around a trend pace. This would once again overshoot the Bank of Canada's most recent 1.0% annualized estimate for Q2 growth.

The surge in Canada's population over the past year has been a big swing factor in the economy. Canada welcomed 292,000 more people in the first three months of the year, bringing the 12-month total to above 1.2 million. With more people living and working in the country, consumer spending surged by nearly 6% q/q annualized in Q1. Firms have struggled to keep up with rising demand, so they have been hiring more workers, boosting wages, and raising prices.

Inflation is showing more persistence than anticipated, while strength in the labour market just won't quit. Along with these data points, the hotter-than-expected GDP report swings the pendulum further towards action on rates by the Bank of Canada. Although it may be too early for policymakers to consider another rate hike at the next meeting on July 12th, if the data keep coming in hot, another move sometime this year is certainly on the table.

Canadian Fixed Income Performance

The FTSE Canada Universe Bond Index (the "Index") increased 0.04% in June. Within the Index, government bonds decreased -0.02%, underperforming the Corporate sector, which increased by 0.21%.

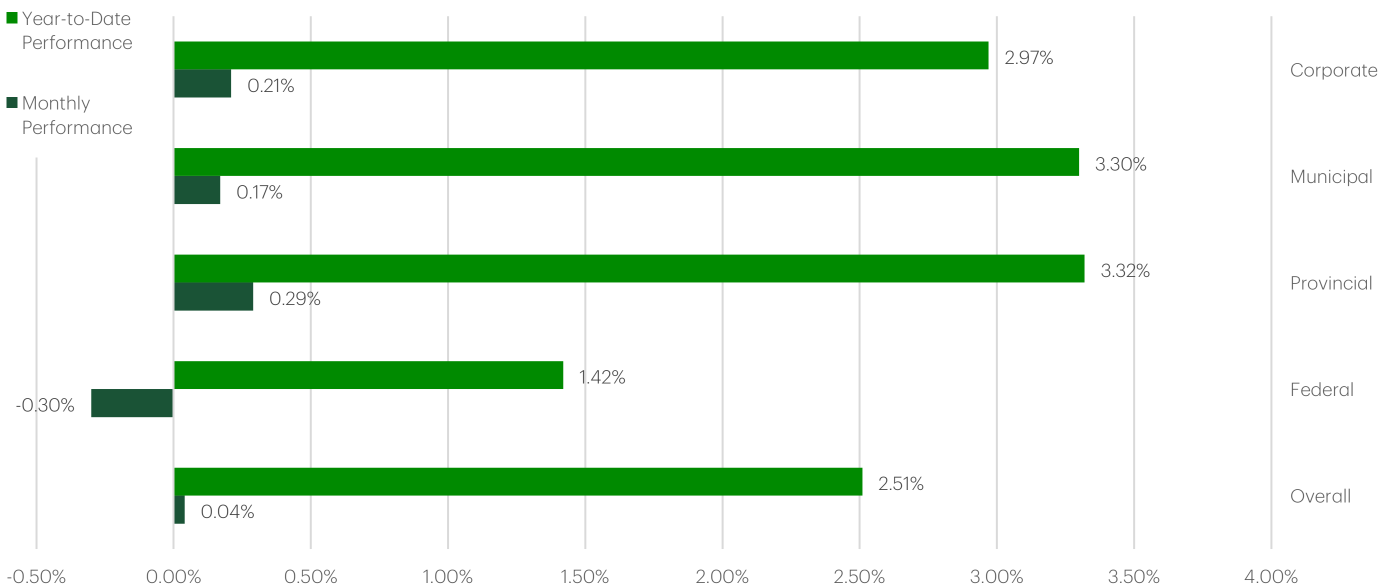
Among corporate issuers, Infrastructure and Energy sector bonds posted the largest increases, while Securitization bonds posted the largest decrease.

AAA/AA-rated bonds posted a decrease of -0.14%, A-rated bonds increased by 0.26. BBB-rated bonds increased by 0.22%.

Federal bonds posted the largest decrease in the Government sector, falling -0.30%.

Long-term bonds outperformed short-term and mid-term bonds.

FTSE Canada Universe Bond Index



Source: FTSE Russel® Debt Market Indices. As of June 30, 2023.

Sectors

Sector	Duration (Years)	Yield	Index Weight
Overall	7.39	4.37%	-
Federal	6.24	3.89%	37.97%
Provincial	9.83	4.15%	34.26%
Municipal	8.68	4.30%	1.99%
Corporate	5.75	5.36%	25.78%

Source: FTSE Russel® Debt Market Indices. As of June 30, 2023.

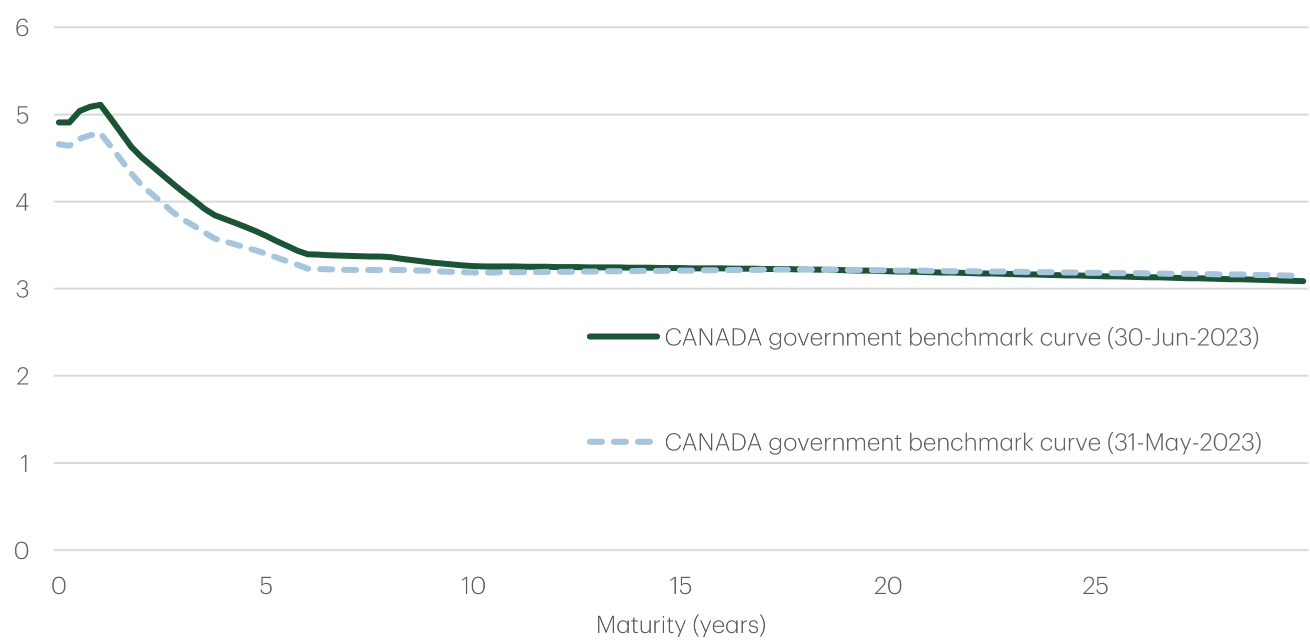
Yields and Interest Rates

While bond yields have increased dramatically in 2022, there is still the potential for rates to increase even further, led by short-end bond yields.

Month-over-month ("MoM"), the Canadian 1-year yield **increased 32 bps** and the 2-year yield **increased 32 bps.** The Canadian 30-year yield **decreased by 5 bps**. As a result, the yield curve steepened further over the month.

The difference in yield between a 2-year and 30-year Government of Canada bond was **142 bps, 38 bps higher** than the previous month.

Canadian Yield Curve



Source: TD Securities. As of June 30, 2023.

Inflation

Headline inflation did cool to the lowest pace in two years in May. However, progress on the BoC's core measures is much slower. This raises concerns that inflation will remain stuck above the Bank's 2% target.

The Bank of Canada's core inflation metrics decelerated, but to a lesser degree than the headline figure, averaging 3.9% y/y in May, versus 4.3% y/y in April.

The U.S. Federal Reserve's officials are also going to stay focused on tightening policy to cool the price pressure as inflation is showing little sign of relenting.

Key Rates	Rates
Bank of Canada	4.75%
U.S. Federal Reserve	5.25%
3-month LIBOR (USD)	5.54%
Canada 10YR Bond	3.27%
U.S. 10YR Treasury	3.84%

Source: TD Securities. As of June 30, 2023.

Economic Overview

Canadian Overview

Canadian equities, as measured by the S&P/TSX Composite Total Return Index posted a positive return of 3.35% ($C) in June. While the gross domestic product (GDP) print for April was unchanged, the flash estimate for May showed a big increase. This sets up second quarter GDP to come in above the BoC's forecast.

Consumer price inflation cooled to 3.4% year-on-year (y/y) in May, down from 4.4% in April – right in line with market expectations. This marks the slowest pace of inflation in nearly two years. Prices at the pump were the main story. Favourable base year effects leave gasoline prices down 18.3% lower than a year ago. Excluding gasoline, the Consumer Price Index (CPI) rose 4.4% in May, following a 4.9% increase in April.

Shelter inflation eased slightly to 4.7%, down from 4.9% in April. Mortgage interest cost inflation keeps rising, up 29.9% versus a year ago in May. Statistics Canada (StatCan)[1] cited that it is the largest single contributor to the year-on-year pace of inflation. Excluding higher mortgage costs, inflation would have been 2.5% y/y in May.

There were signs of easing price pressures for consumer goods. Clothing and footwear inflation was 0.7% y/y in May, down from 2.5% y/y in April and furniture prices were down 2.9% y/y, the smallest increase in three years. Overall durable goods inflation cooled to 1.0% y/y in May from 2.2% in April.

The Bank of Canada's underlying inflation pressures cooled below the 4% mark in May. Although there has been a notable improvement in overall Canadian inflation, underlying core measures reveal a big challenge going forward. The economy has continued to grow at a very healthy rate, supported by a surging population, which saw Canada welcome 292,000 people in the first three months of the year. This has kept up pressure on wages and domestic prices. Recent economic data prompted financial markets to cement expectations for another rate hike this summer.

U.S. Overview

U. .S. equities, as measured by the S&P 500 Index, posted a positive return of 6.47% ($C) in June. Activity in the housing market has improved, new home sales rose to their highest level in May since February 2022. Real consumer spending grew slightly above market expectations in April, but consumer sentiment has continued to trend lower in recent months. This is in line with expectations for a more moderate spending growth profile this quarter.

The industrial side of the economy saw manufacturers' new orders of durable goods blow out expectations for a contraction. Taking a closer look at a key indicator of business investment, new orders excluding defense and aircraft advanced a solid 0.7% in the month, and 0.3% month-on-month when stripping out the effects of inflation.

May's consumer spending report suggests that demand has paused from its strong start to the year. Real expenditures were flat for the third time in four months, as an advance in services spending was offset by a drop in goods spending. Moreover, it looks like consumers are adjusting habits as they save a bit more of their disposable income. The personal savings rate ticked up to 4.6% in May, nearly two percentage points higher than its low registered in June 2022.

However, core personal consumption expenditures (PCE) inflation is showing little sign of relenting, up 4.6% y/y, with the near-term trend cruising along at 4.4% annualized. Inflation has been stuck well above the two percent target, which is likely to keep officials focused on tightening policy to cool it down. Markets are looking for the Fed to hike rates again this year by another 25 basis points – taking the policy rate to a 22-year high of 5.5%. The Federal Open Market Committee's next decision is at the end of July, giving it some time to see a few more readings on economic momentum before making its decision.

[1]Source: Statistics Canada, as at June 30, 2023

Glossary of terms

Bond Spreads: The difference between yields of bonds with similar quality and different maturities, or of different quality and the same maturity. Typically, the higher the spread, the higher the risk.

bps: Basis points. One basis point is equal to 0.01%.

Breakeven Rate: A market-based measure of expected inflation. It represents the difference between the yield of a nominal bond and an inflation-linked bond of the same maturity.

CDOR: Canadian Dollar Offered Rate, is the recognized financial benchmark in Canada for bankers' acceptances (BAs) with a term of maturity of one year or less. It is the rate at which banks are willing to lend money to companies.

Corporate Bonds: Debt security that is issued by a company in order to raise capital.

CPI: Consumer Price Index, an indicator that measures the changes in prices of a basket of consumer goods and services.

Credit quality/rating: Refers to a bond's credit worthiness or risk of default.

Duration: A method of estimating a bond's price volatility, expressed in terms of the weighted average term-to-maturity of all the bond's remaining cash flows—interest and principal.

GDP: Gross Domestic Product, the monetary value of all finished goods and services made within a country during a specific period.

LIBOR: London Interbank Offered Rate, the interest rate at which banks offer to lend money to one another in the international interbank market for short-term loans.

MoM: Month over month.

Provincial Bonds: Debt security issued and backed by provincial governments.

Yield Curve: Graphical representation of the relationship between the yields and maturities of different bonds of similar quality, currency denomination and risk (usually government bonds).

YoY: Year over year.

YTD: Year to date.