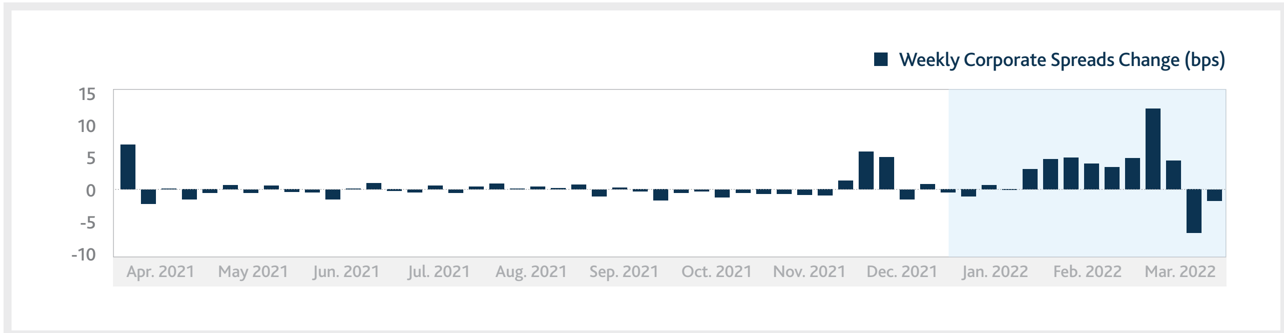
MAY 2022

What to Expect When Expecting Rates to Rise

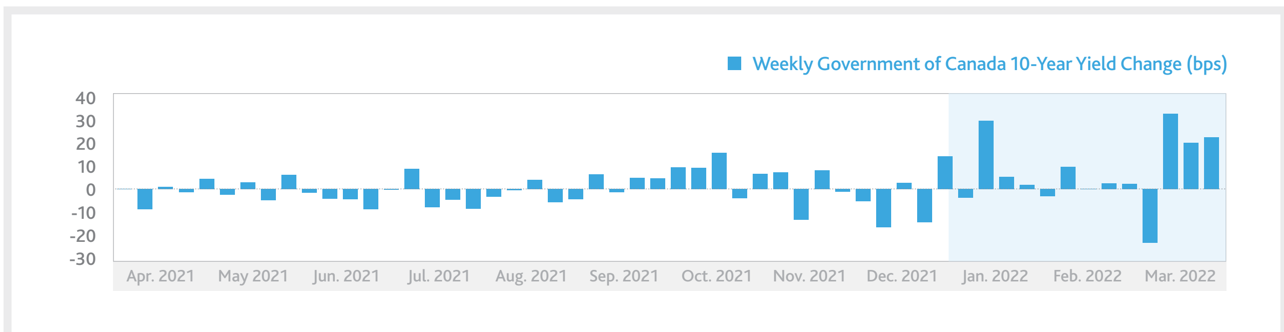
2021 saw financial markets that were defined by transitioning expectations. Pivotal inflection points included the Bank of Canada's mid-year hawkish turn and the US Fed's year-end drop of "transitory" when describing inflation. In response, interest rate volatility increased and credit spreads widened, as markets prepared for the eventual transition to less accommodative policies from central bankers. The resiliency of the economic recovery is expected to be put to test.

Volatility Has Increased Across Sectors

Corporate Spreads



Government of Canada 10-Year Yield



Source: Fiera Capital, FTSE Russell's Global Debt Market Indices, Bloomberg Financial LP.

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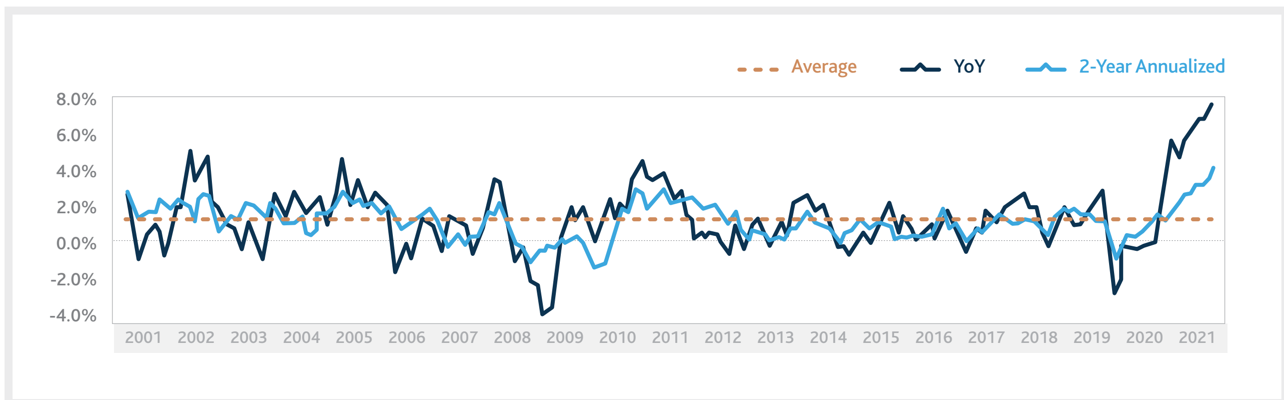
North American policy rates have now come off their effective lower bounds, however, we do not have clarity on how high rates need to be and how quickly they need to get there to tame inflation without completely short-circuiting the recovery. We are in a shifting regime from rate hike anticipation to appraisal. Last year was about anticipating the timing and pace of policy moves, whereas this year is likely to be driven by evaluating the effectiveness and progress towards central bankers' objectives given such moves. The path forward has many variables to consider leading to a wide-range of potential outcomes.

For the first part of 2022, financial markets have focused on decades-high inflation and its implications on central bank policy. However, intensifying geopolitical tensions have added another layer of complexity to an already fragile backdrop. The Russian invasion of Ukraine is emboldening both downside risks to global growth and upside risks to inflation. The immediate financial response to the conflict has been a flight-to-quality, with equity and corporate bond valuations weakening. However, bond yields have subsequently moved higher.

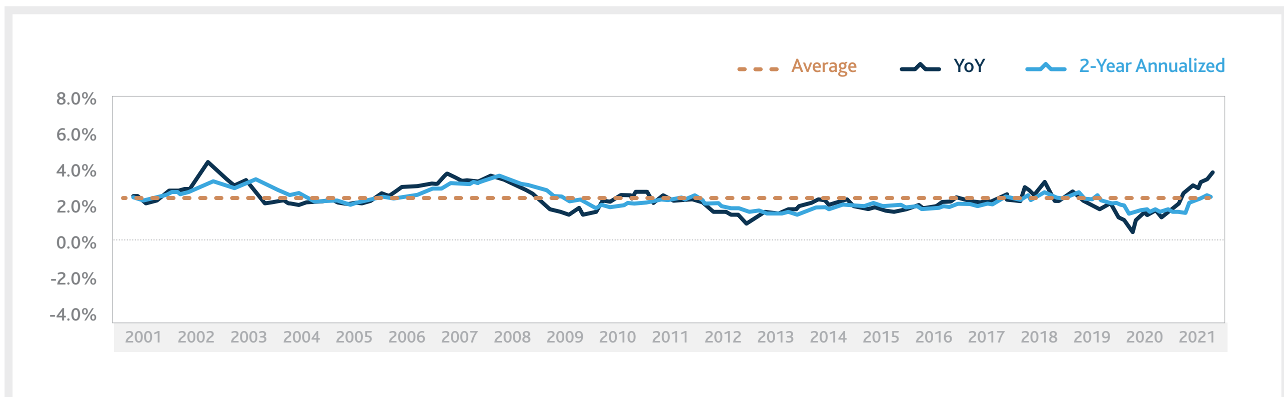
At this point, the channel of transmission to North American markets from the conflict is a deterioration in sentiment, tightening financial conditions and higher oil prices, however, more clarity on the severity and longevity is required to assess the full-extent of the impact. The rapid rise in commodity prices comes at a time when consumers are already facing rising inflation, acting as a tax on consumption, as well as higher input costs on businesses placing further pressure on profit margins. This may lead to a modest drag on growth. The evolving backdrop leaves central bankers in a precarious situation as they seek to contain the strongest price pressures in decades without derailing the post-pandemic recovery. Broadly speaking, the wide range of potential outcomes only further justifies our consensus expectations for volatility to remain elevated in 2022.

Canadian Inflation Accelerating in Goods and Services for Both YoY and Since Pre-pandemic

Goods – 49% of Consumer Price Index (Change %)



Services – 51% of Consumer Price Index (Change %)



Source: Statistics Canada, Table: 18-10-0004-01, as of February 28, 2022.

Ask the experts

Fiera Capital brings a diverse team of fixed income and private debt investment professionals as stewards of capital across multiple client segments. We have built a resilient, well-resourced, research-driven fixed income platform that has resulted in strong capabilities with varied sources of alpha-generation to develop client-focused solutions. Rates, curve, credit and liquidity are all sources of risk that provide our active managers with opportunities to exploit market dislocations.

We have asked our experts across fixed income, private credit and fixed income solutions teams to provide their insights and outlook on the market to investors amidst the uncertainty. We asked them the following questions:

- How has the current market volatility shaped your top-down market strategy?
- How are rising rates and declining growth expectations influencing the shape of the Canadian yield curve and are there sectors your strategy favours in this environment?
- As we consider the implications of the pandemic, inflation, geopolitical tensions and policy tightening, what do you believe will be the primary focus for financial markets over the next 12-months?
- Where are you finding value across corporate credit sectors?
- How has the pandemic and subsequent recovery affected investor demand for private credit?
- How has private debt origination been impacted by the pandemic and recovery?
- As inflation approaches record highs and central banks remove accommodative policies that have supported business, what are important characteristics the private credit team looks for in their portfolio of companies?
- How has the recent volatility in the market impacted the nature of the discussions on fixed income solutions that are being sought or discussed with clients?
- What advice would you give to investors as they construct fixed income solutions in the current environment?

Charles Lefebvre
CFA, FRM

Lead and Senior
Fixed Income Portfolio Manager,
Active and Strategic Fixed Income

How has the current market volatility shaped your top-down market strategy?

Our view is that growth will remain above potential in 2022, however there are evident downside risks. For starters, inflation is likely to remain well above the Bank of Canada and the US Federal Reserve's targets, justifying rate hikes over the course of the year. However, the deterioration in sentiment from rising geopolitical risks may temper some of the more aggressive policy path expectations. Central bankers are likely to find themselves weighing the risks of persistently high inflation with the growth dampening effects of tighter financial conditions – both from higher policy rates and weaker confidence. We believe the bouts of elevated volatility that have helped define the first months of 2022 are likely to persist over the next several quarters.

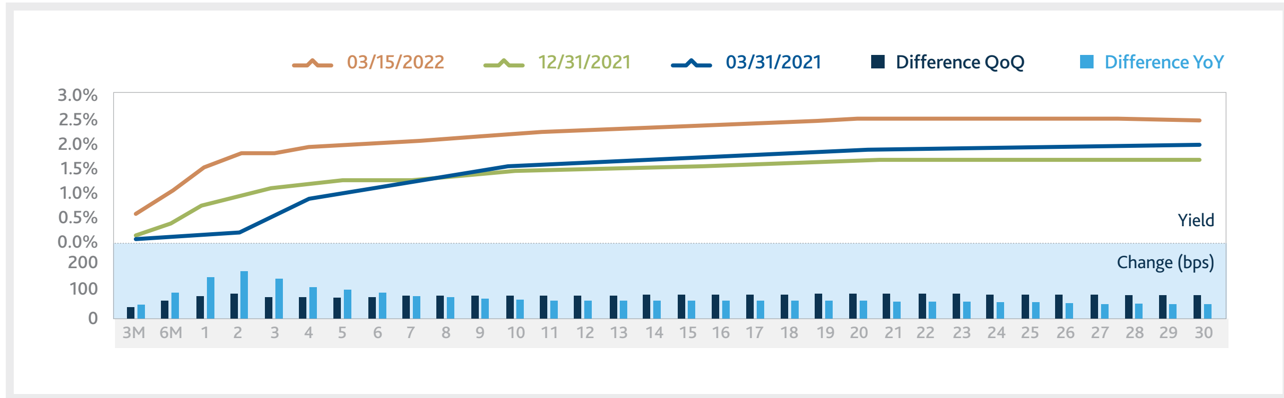
Our outlook reflects the increasing risks, which include tighter monetary policy, retreat from high valuations, persistent inflation, overhang of COVID-19 and escalating geopolitical tensions. Last year, we identified opportunities to take advantage of rate volatility by establishing long duration positions as rates gradually increased towards oversold ranges and were well positioned to benefit from swift risk-off episodes when market sentiment turned. We also held an overweight to high quality spread product over most of the year, benefiting from tightening credit spreads. We consequently took profits and reduced active risk. We entered 2022 with, and maintain, a more defensive posture.

How are rising rates and declining growth expectations influencing the shape of the Canadian yield curve and are there sectors your strategy favours in this environment?

In this environment, we favour diversified sources of added-value and high-quality income to conservatively improve portfolio yield. We favour defensive, stable sectors with strong

Short-Term Rates Have Risen Most and Incremental Yield for Moving Out the Curve Has Declined

Government of Canada



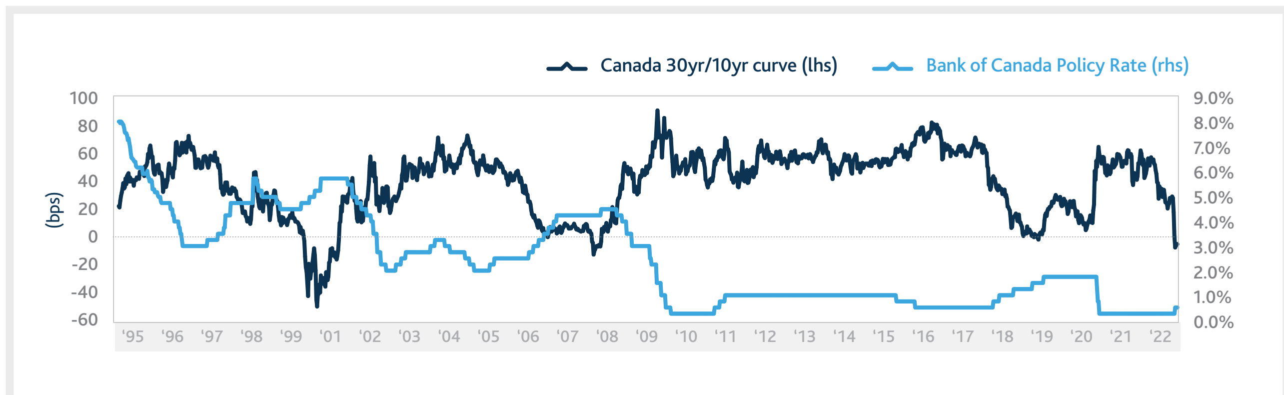
Source: Fiera Capital, Bloomberg Financial LP, as of March 15, 2022.

liquidity profiles where we believe spread volatility will be lower compared to higher-beta sectors. This includes provincial, municipal and financial sectors, as well as moving up in credit quality. The latter results in an underweight to BBB-rated bonds and corporate bonds in general. We want to have dry powder within the portfolio to ensure we can efficiently react to the evolving economic and market backdrop.

Consistent with our contrarian investment approach, as the Canadian Government yield curve has flattened, we have incrementally reduced exposure to the short- and long-term sections of the curve, moving to outright underweights. This position is offset by favouring an overweight to mid-term maturity bonds. The curve flattening really stands out, with the yield difference between the 30- and 10-year Government of Canada reaching cycle lows. When comparing the yield curve at this early stage of the rate hike to historical tightening cycles, it is significantly flatter this time around. The market is effectively expecting policy rates to rise quickly and reduce inflation and growth from their elevated levels. Curve flatness results in limited incremental yield for extending duration at this point, supporting our move to the center of the curve.

We are finding some attractive relative value in longer term bonds, such as provincials, where yield pick-up is more attractive relative to shorter maturities. Our bias is to maintain higher levels of liquidity and opportunistically take advantage of more attractive valuations amidst the market volatility.

Curve Flattening Is Well Advanced Versus Historical Tightning Cycles



Source: Fiera Capital, Bloomberg Financial LP, as of March 15, 2022.

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Philippe Ouellette
MSc, CFA

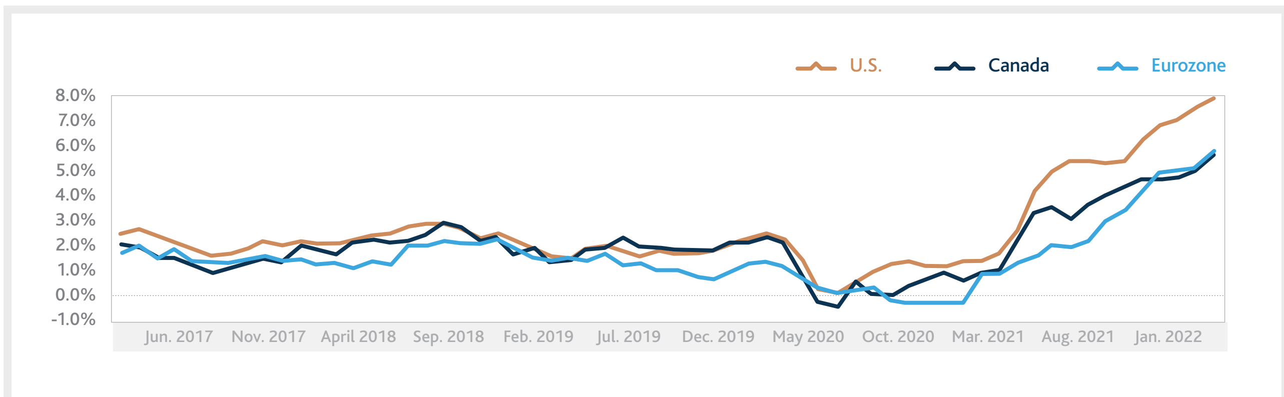
Lead and Senior
Fixed Income Portfolio Manager,
Integrated Fixed Income

As we consider the implications of the pandemic, inflation, geopolitical tensions and policy tightening, what do you believe will be the primary focus for financial markets over the next 12-months?

Since the second half of 2021, it has been our belief that COVID virus trends will have less influence on financial markets as focus shifts to inflation dynamics and the normalization path of central bank policy. We believe the shift is now well entrenched. There are now lower odds of further negative impacts in 2022 from the pandemic, while growth and valuations have all eyes on central bankers over the next leg of the cycle. Geopolitical risk tied to the situation in Russia and Ukraine has moved to the top of our list of key risks for the market and we see a substantial increase in tail risks stemming from this conflict. The odds of an extended conflict with a more persistent negative impact on the growth outlook is high and increases the risks of a more material slowdown over the next 12-24 months. Credit risk and liquidity premiums have increased and are factored into our strategy.

Global Inflation Showing No Signs of Abating

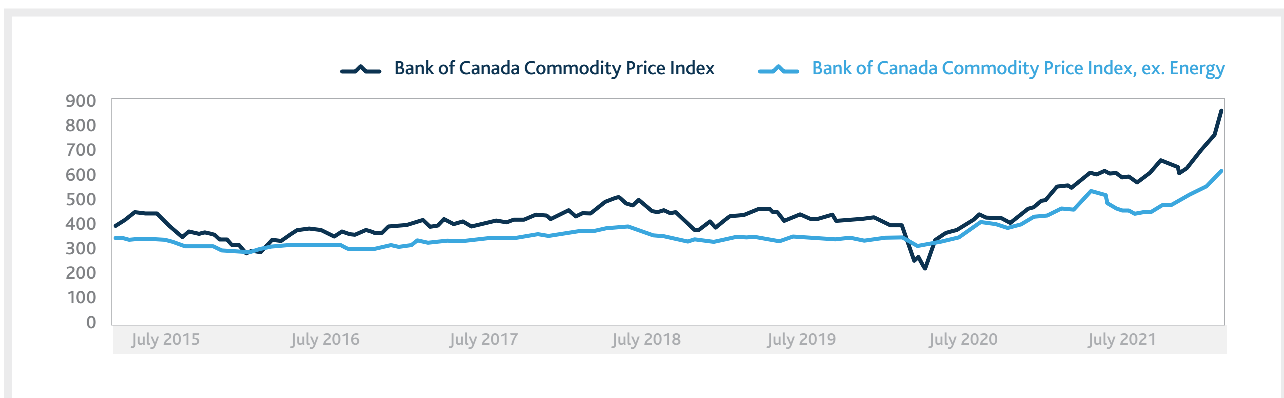
Global Change in Consumer Prices Year-Over-Year



Source: Bloomberg Financial LP, US/Canada: Consumer Price Index, Eurozone: Harmonized Index of Consumer Prices, as of January 31, 2022.

Increases in Commodity Prices Is Not Just About Energy

Average Price



Source: Bank of Canada.

On the inflation front, we believe it will take time to decrease towards levels that are deemed tolerable by central banks. The Russia/Ukraine conflict is adding substantial pressure on inflation, especially through higher oil and commodity prices, while supply chain issues continue to persist. This will pressure central banks in 2022 to normalize rates and contribute to some higher than average bond market volatility. The tightening cycle is likely to consist of two phases: an initial push higher in consecutive meetings to establish creditability on their inflation mandate, followed by a period of data dependency as they evaluate the progress and next steps to meet their goals. We have high conviction on the former, however the latter is less clear and will primarily depend on the extent of the deceleration in inflation and sustained consumer strength, as well as the future trajectory of the Russia/Ukraine conflict.

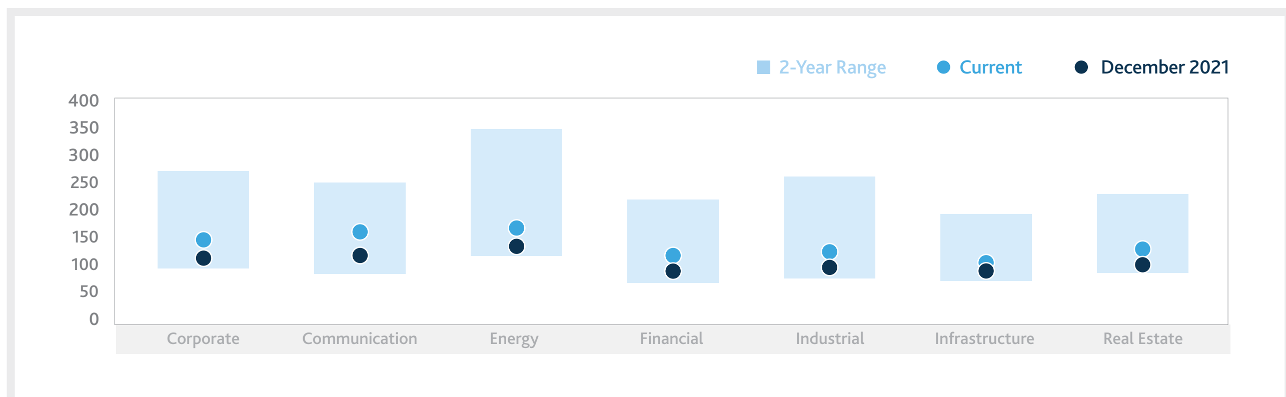
Where are you finding value across corporate credit sectors?

Our focus is on avoiding uncompensated risk across credit, interest rates and liquidity. In 2021, we rotated across strategies using our fundamental relative value framework, which included moving into credit sectors where spread tightening lagged the broader market, buying real return bonds to hedge against rising inflation-expectations and shortening relative portfolio duration. Issuer selection and idiosyncratic risk are core considerations within our credit research process and will continue to be an important contribution to alpha going forward – by identifying issuers with an ability to navigate this turbulent market and inflationary environment while providing appropriate risk-compensation.

Canadian corporate credit spreads started to move off their lows late last year. The move towards widening spreads has been more pronounced thus far in 2022 as rate hikes came into view, coupled with the escalating geopolitical tensions. We began modestly adding back credit risk in high-quality sectors at the beginning of the year given the valuation improvement, following several quarters of profit taking. The spread change in Canadian corporate spreads are at levels consistent with the higher end of spreads outside recessions and systematic episodes. We are cognizant of the risk for spreads to breakout higher as risk premia increase and we are being strategic in where and how we add back credit to portfolios.

We have focused our credit overweight in shorter-term corporate credit where visibility and predictability of outcomes is highest in well-known issuers with sound fundamentals. The geopolitical tensions have increased risk and liquidity premia substantially. With volatility increasing, pockets of illiquidity have emerged, which we can take advantage of by being a liquidity provider in issuers where we have a well-established and constructive thesis to add long-term value.

Spreads off Lows and Widening Aross Sectors YTD
Spread (bps)



Source: Fiera Capital, Bloomberg Financial LP, as of March 15, 2022.

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Theresa Shutt
CFA, MBA, M.A.

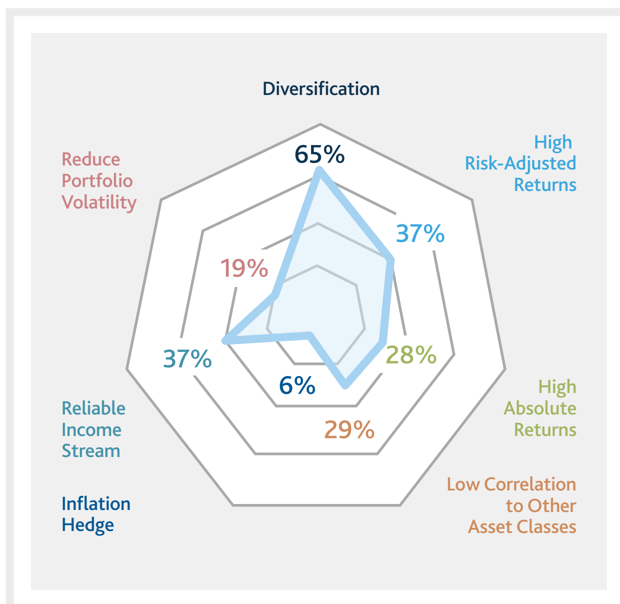
Senior Vice President,
Corporate Debt Financing,
Fiera Private Debt

How has the pandemic and subsequent recovery affected investor demand for private credit?

As an asset class, private debt has continued to see very strong investor inflows. This trend largely began post-GFC as regulatory changes forced traditional bank lenders to the sidelines. Non-bank lenders stepped in to fill the void and significantly increased the profile and breadth of investment opportunities in private debt. In addition, persistent low interest rates have put downward pressure on yields for corporate and government bonds. As a result, investors looking for yield and safety have gravitated towards private debt. Throughout the pandemic, investor appetite for private credit remained robust and has further accelerated as economic conditions shifted as we emerge from the pandemic.

Drivers of Allocation to Private Debt

Proportion of Respondents



Source: Preqin, 2020 Preqin Global Private Debt Report.

91% OF SURVEYED INVESTORS INTEND TO MAINTAIN OR INCREASE ALLOCATIONS TO PRIVATE DEBT OVER THE LONG TERM.

Source: Pregin, 2022 Pregin Global Private Debt Report.

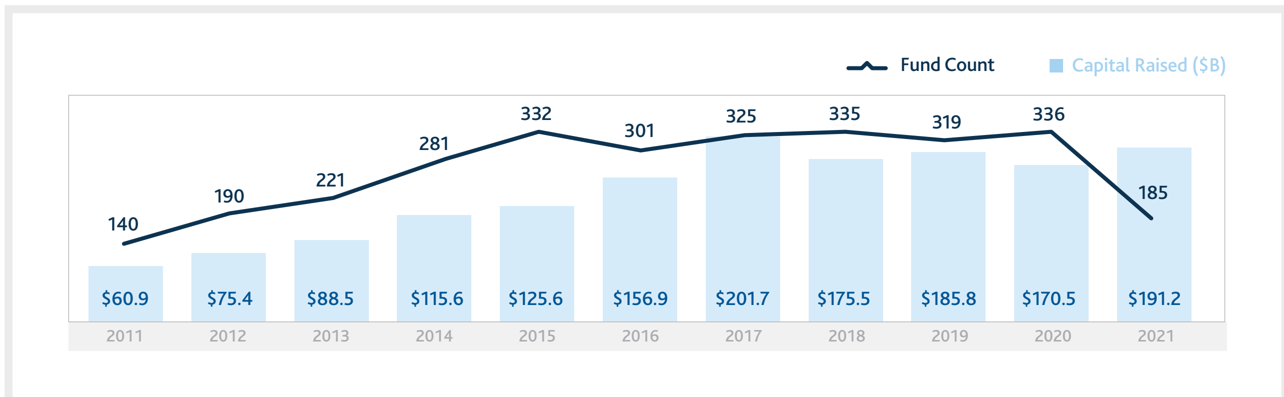
Post-pandemic, rising inflation concerns and central bank tightening policies have driven rates higher. However, rates are still low by historical standards. While rising interest rates have a negative impact on fixed income valuations, higher cash coupons paid by private debt investments help to cushion portfolios from a moderate increase in rates. In addition, the illiquid nature of private debt means loans are significantly more insulated from volatility stemming from short-term changes in market rates and investor sentiment. We continue to see increased interest in, and allocations to, private debt as investors seek to complement existing fixed income allocations to generate enhanced yield while achieving greater safety through strong covenant protection and diversification benefits.

How has private debt origination been impacted by the pandemic and recovery?

On the supply side, capital raised by private debt funds has also increased as we recover from the pandemic. However, the dramatic decline in the number of funds raised is significant; ***the average fund size has more than doubled between 2020 and 2021*** as capital gravitated towards larger, more well-known funds. The M&A boom, fueled by accommodative monetary policy and lofty equity valuations, has created significant demand for private financing. This, coupled with durable investor demand for private debt, has led to this dramatic increase in average fund size. As a result, there is significant competition for deal sourcing at the larger end of the market which has begun to price with looser covenant packages and downward pressure on yields.

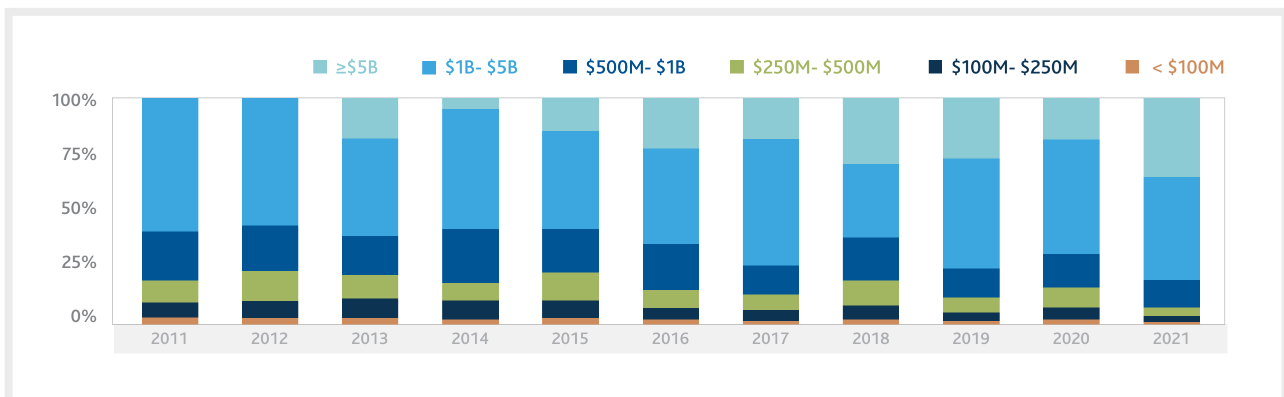
The combined result of these dynamics is that high-quality, smaller businesses are left under-represented and underserved. Typical loan sizes in the mid-market arena simply can't move the needle for large and mega funds where private debt capital is concentrated. The result has been significant opportunities for experienced, mid-market lenders to reap strong, consistent cash yields without compromising on the quality of borrower or giving up covenant protections.

Private Debt Fundraising Activity



Source: Pitchbook. Geography: Global. As of December 31, 2021.

Share of Private Debt Fundraising Value by Size



Source: Pitchbook. Geography: Global. As of June 30, 2021.

As inflation approaches record highs and central banks remove accommodative policies that have supported business, what are important characteristics the private credit team looks for in their portfolio of companies?

The team is particularly focused on assessing the financial strength of borrowers who are more exposed to inflation. While labour shortages, supply chain disruptions, and raw material cost-inflation tempered the growth trajectory of some of our borrowers, most of them got closer to, if not exceeded, historical levels of capacity and production. This is partially due to strong management teams, pent-up demand, and the ability to pass on some of these inflation-related costs to their customers. We continue to have conversations with our borrowers and prospects on how each company is dealing with and mitigating the impact of observed and expected inflation. In addition, continued focus on customized covenant packages that allow borrowers the flexibility to take advantage of business opportunities while providing strong lender protections and early-warning triggers will continue to be paramount. Operating outside of the competitive larger end of the market, we continue extract premium loan pricing without sacrificing lender protections. As we look to the rest of 2022, our deal pipeline has continued to grow stronger over the last quarter, as companies seek to refinance and expand their businesses, and M&A activity continues to increase.

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Maxime Carrier
CFA, FICA, FSA, CAIA

Senior Portfolio Manager,
Fixed Income Solutions

How has the recent volatility in the market impacted the nature of the discussions on fixed income solutions that are being sought?

We take a tailored and outcome-focused approach in working with our clients. In the current environment, the nature of discussions has varied based on client objectives, liability profile and risk tolerance. The types of solutions contemplated has varied, reflecting the different role that fixed income plays in client portfolios.

In terms of interest for fixed income as an asset class, many defined-benefit pension plans started the year on solid footing in terms of funded status positions. We have seen continued interest in de-risking in order to lock in gains and better insulate funded positions from market volatility. We have also had discussions with non-profit organizations on applying dedication portfolio strategies to better secure the costs toward meeting a portion of their future spending requirements or commitments.

For insurance companies, which tends to invest a large fraction of their assets in fixed income, higher volatility is occurring at a time where the industry is at critical juncture in its transition to IFRS 17. As a recent **Fiera paper** highlighted, IFRS 17 will have important investment and asset liability management implications for insurers. Given this backdrop, we are having discussions both around 1) investing for the current environment (under current accounting standards) and 2) revisiting the strategic asset mix (for future accounting standards).

For the last decade or so, persistent inflation risk was deemed a very unlikely outcome by many investors. The on-going supply chain disruptions and Ukraine/Russia conflict has certainly provided a concrete scenario through which higher inflation can persist under the current inflation-control target regime. For investors that have return objectives expressed in “real” terms (e.g., pension plans with indexed liabilities, foundations that have spending rates tied to inflation, etc.), there has been more discussion on the role that different assets can play to protect against erosion in purchasing power.

Generally speaking, many investors have voiced their concerns about the outlook for fixed income, and what a rising yield environment would mean. We have had a number of discussions on the potential levers to preserve capital and enhance returns in a more volatile environment. For example, we have seen continued interested in broadening the scope of fixed income solutions to include other income-oriented strategies such as hybrids, private credit, and real assets. We have also had discussions on opportunities to take advantage of volatility, for example by making duration extension conditional on reaching pre-defined “trigger” levels or by giving more leeway to portfolio managers through actively managed strategies.

What advice would you give to investors as they construct fixed income solutions in the current environment?

First and foremost, investors should think about the role of their fixed income allocation within the broader portfolio. The fixed income opportunity set has evolved considerably, and the composition of a fixed income solution will vary based on whether the objective is to hedge mark to market movements in liabilities, support income generation, or provide liquidity to take advantage of market dislocation through cost-effective rebalancing.

Secondly, we think it is important to anchor portfolio design in the current pricing context, and from a total portfolio and asset/liability standpoint (as applicable). Yields and credit spreads are evolving and the outlook for volatilities and correlation across asset classes is changing. From a strategic standpoint, capital market assumptions may need to be reset to the new market environment.

Thirdly, from an implementation standpoint, what our experience has thought us is that transparent and ongoing communication can help improve outcomes during volatile periods. Volatile markets can create opportunities but without open dialogues, it can be hard to fully capture such opportunities.

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Bottom line

Investors face a multitude of risks over the near term. After two years of a pandemic related economic shock, uncertainty persists. As we move onto the next leg of the cycle, it is likely there will be more frequent bouts of elevated volatility. However, with volatility comes opportunity and we believe investors can benefit from taking a disciplined and pragmatic approach to navigate through the current market environment. High quality, income-generating assets are a core holding across client segments for good reasons. They provide stable income, diversification and cashflow-matching benefits. As rates move higher, the yield curve changes, and valuations adjust. An active approach can help to protect capital and find opportunities to capture alpha. For investors with an ability to lower their portfolio liquidity, private credit is complementary to traditional income. By harnessing an illiquidity and complexity premium that exists in private credit, investors can further enhance and stabilize income generation over the long term. We recognize that fixed income can play a different role across various client portfolios. In general, we believe an outcome-focused approach that considers a broader set of potential levers and considers the role of fixed income in a total portfolio context can help investors preserve capital and enhance returns in this more volatile environment.

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