

FIXED INCOME OUTLOOK

H2 2024

Summary

- The odds of an economic downturn in the coming 12 months have fallen to their lowest level since 2022 for Developed Markets (DM).
- Most DM central banks have begun to move toward a less restrictive policy stance as inflationary pressures continue to moderate.
- The Global Purchasing Managers' Index (PMI), which measures the prevailing direction of manufacturing activity, points to continued growth in the months ahead.
- Business activity has kept demand for workers elevated as job vacancy rates generally remain above pre-pandemic levels worldwide.
- Real global growth is expected to be positive at slightly below pre-pandemic levels through the second half of the year.

Fixed Income Positioning

- The positive baseline economic outlook skews in favour of exposures further out on the yield curve.
- The prospect of a reallocation of almost C\$1 trillion in the fixed-term deposits and money market funds in Canada, to mitigate reinvestment risk, could serve as a tailwind for longer-duration bonds.
- For cash alternatives, as interest rates on Guaranteed Investment Certificates and High Interest Savings ETFs move lower with Bank of Canada (BoC) rate cuts, our suite of GuardBonds™ target maturity funds appear more attractive on a relative basis due to the yield differential.
- We prefer a bulleted structure portfolio, concentrated in higher quality mid-term corporates, currently employed in our Guardian Investment Grade Corporate Bond Fund.
- With risks being asymmetrically skewed to credit spreads widening, we have implemented portfolio credit hedges within the Guardian Strategic Income Fund.

Upon further inflection

The expectation that the long-awaited slowdown in global economic momentum would finally materialize in the first half of this year and spur central banks to aggressively cut policy rates, once again, disappointed.

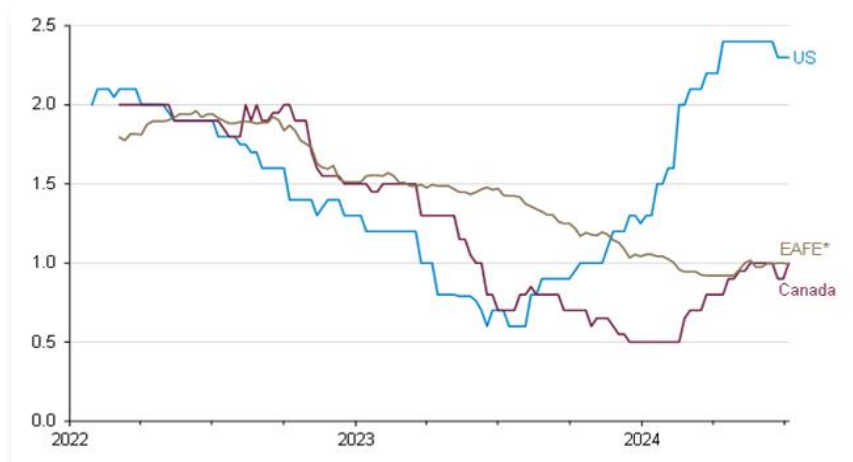
Instead, 2024 so far, has largely just a been repeat of the scenario that has played out persistently over the last three years, in which actual growth has continued to chug along at a decent pace unabated, and kept performance in fixed income markets underwhelming.

If anything, the biggest change concerning growth so far this year, relative to the preceding period, is the evidence of a broadening out beyond the US economy. Regions such as Europe, Japan and Emerging Markets (including China) that had stagnated in the second half of 2023, stabilized early this year and, more recently, have shown nascent signs of improvement.

The broad slate of leading economic indicators is pointing to widespread improvement in momentum across the globe as the second half of 2024 begins. The general upward inflection in the dataflow is translating into more broad-based upward revisions to growth forecasts for the current year.

For sure, the US continues to play a key leadership role — and given its position at the forefront of the technological developments associated with artificial intelligence, is likely to stay there for the foreseeable future — but the upgrades elsewhere are narrowing the anticipated performance gap.

Consensus real gross domestic product forecast, 2024 (year-over-year percent change)



*EAFE=Developed Europe, Australasia & the Far East
Source: Guardian Capital using data from Bloomberg to July 12, 2024

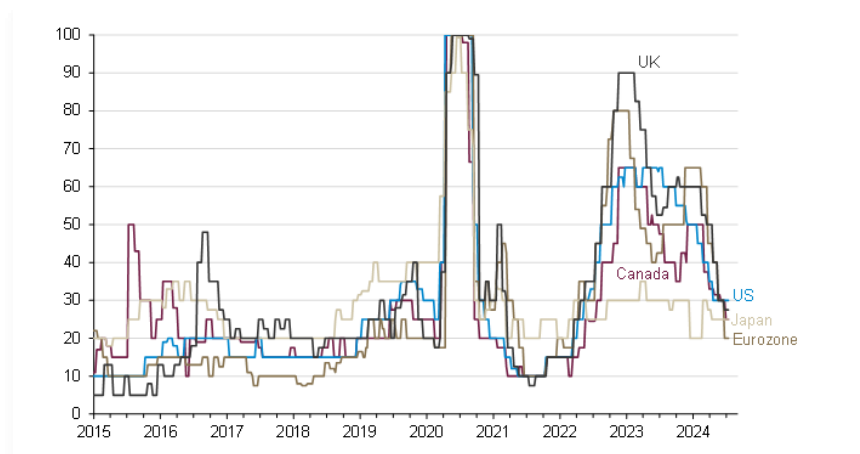
In a notable contrast to the last few years, however, it appears that forecasters are no longer just trading near-term strength for weakness later on and kicking out recession calls down the road. The downward inflection for growth that had been assumed to be coming has been replaced by a fairly flat and stable trajectory across the forecast horizon.

The current consensus is for real global growth to maintain rates going forward that are generally consistent with what has ultimately prevailed over the last two years, which represents just a marginal step down from pre-pandemic trends.

Further to this point, an imminent recession is no longer being treated as a high-probability event.

The estimated odds of an economic downturn in the coming 12 months have fallen to just 1-in-4 across DM, its lowest level since 2022 — it remains somewhat elevated relative to other periods of “sustained” growth and above the 1-in-6 odds of a recession in any given year historically.

Consensus expected probability of recession in 12 months (percent)



Source: Guardian Capital using data from Bloomberg to July 12, 2024

Convincing arguments

The ongoing caution over the outlook is certainly warranted, given the continued risks (discussed below), but the diminished expectations of the worst potential outcomes simply reflect even the more bearish forecasters succumbing to the weight of the evidence.

For starters, despite concerns that consumers are running out of gas following years of pandemic stimulus-related resilience, there are limited signs, so far, of weakness in household spending. A prime example of the continued strength on this front is that expenditure on things such as entertainment and travel, generally considered among the most discretionary of discretionary spending, remains quite firm.

Spending on goods that surged amid peaks of the pandemic has also remained resilient and continued to run at elevated levels. Retail spending, on an inflation-adjusted basis, has not registered much of a give-back from its break higher from the trend despite elevated price pressures.

Echoing this demand for consumer goods, international trade flows have turned for the better this year. Growth in import and export volumes has perked up, and there has been particular strength

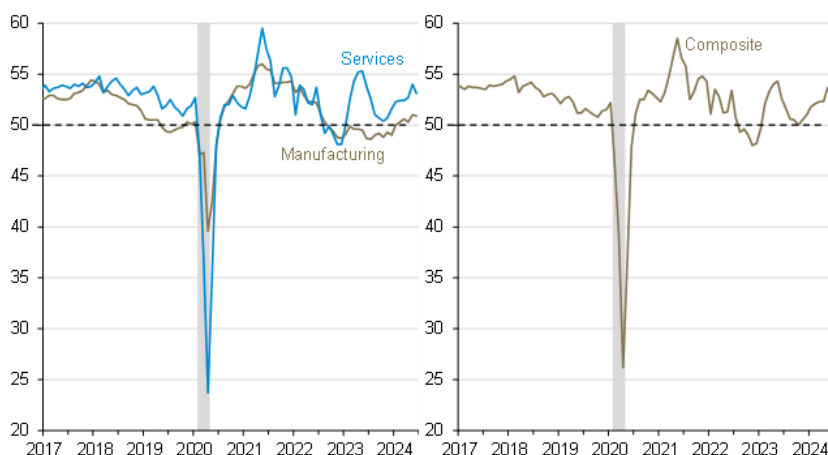
in Emerging Markets (EM) that play a significant role in the supply chain.

Finally, the momentum has been further confirmed by the bellwether global manufacturing PMI. The forward-looking gauge of factory activity just closed out its best quarter in two years, with the regional participation in the expansion of goods production broadening out notably.

At the same time, the global PMI for the more economically important service sector has seen its moderate upward momentum sustained so far through 2024, with the second quarter marking its best outturn in a year. The composite PMI, aggregating countries and sectors (a proxy for global growth) had its strongest quarter in a year as well, pointing to continued growth in the months ahead.

Purchasing managers indexes, World

(diffusion index; >50 denotes expansion)



Shaded regions represent periods of US recession; source: Guardian Capital using data from Bloomberg to June 2024

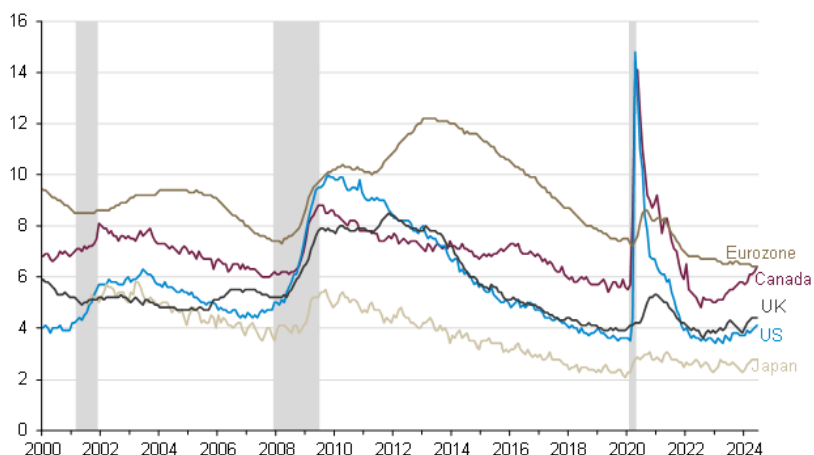
Keep the economy working

The solid levels of business activity have kept demand for workers elevated. While well off their earlier peaks, job vacancy rates generally remain above pre-pandemic levels worldwide.

As well, layoffs remain benign and, while the decline in “quits” suggests some marginal cooling in the market, it also points to businesses’ efforts to retain staff in a market that still favours workers — this is corroborated by wage inflation, which remains elevated, though it has moderated from earlier peaks.

As a result, unemployment rates remain near their historic lows globally — the notable increase in Canada reflects surging population growth, not job loss, in a welcome indication of easing constraints within the job market rather than signs of outright weakness as of yet.

Unemployment rates (percent)



Shaded regions represent periods of US recession; source: Guardian Capital using data from Bloomberg to June 2024

A still firm backdrop for employment bodes well for continued income growth, which, combined with the strength in finances — household balance sheets, in general, remain in solid shape against ample savings, strong financial markets and firm home prices — suggests there is still scope for consumers to continue to serve as a driver for global growth.

Threats neutralized?

The outlook for consumers is also supported by the fact that underlying inflationary pressures have continued to moderate, giving a boost to household purchasing power.

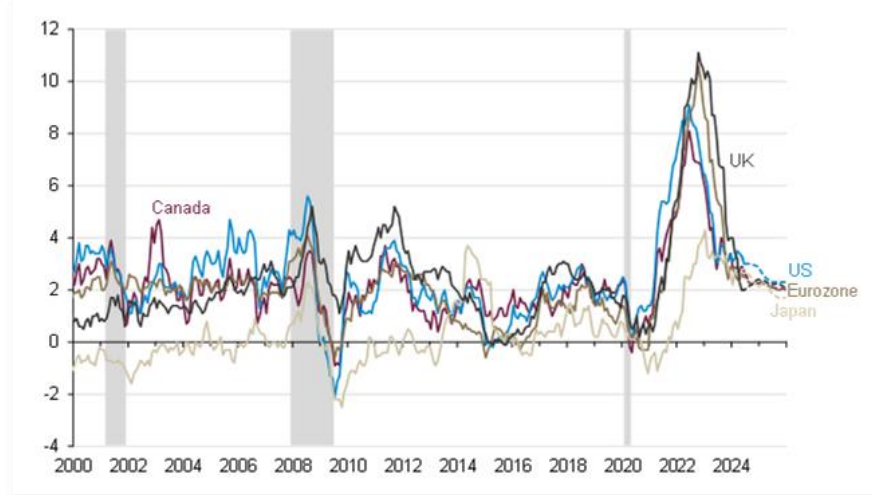
Echoing the improvement in trade flows, the damaged links in the supply chain have been repaired, driving a material easing in supply-side price pressures that played a significant role in pushing inflation rates higher worldwide. Similarly, price pressures in the production pipeline have plunged. China, often the first step in the value chain, has seen producer prices outright deflate for nearly two years.

Even with still firm underlying demand, this has factored into the sustained downtrend in the rate of increase in consumer prices. Easing costs of labour and raw inputs to production, and the lagged impact of the moderation in home prices and rent increases, are playing their part as well.

Overall inflation remains elevated, but it has fallen back within reach of central bank targets in many regions and is expected to move down to even more tolerable levels over the forecast horizon.

Consumer Price Index

(year-over-year percent change)



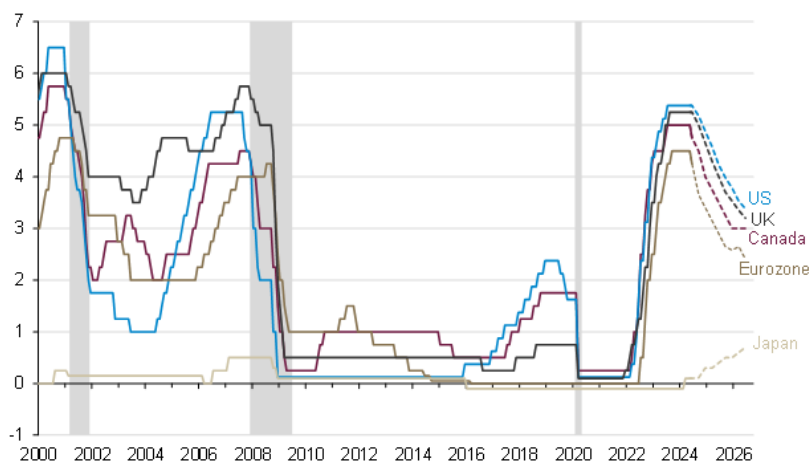
Dashed lines represent consensus forecasts as at April 19, 2024; shaded regions represent periods of US recession; source: Guardian Capital using data from Bloomberg to June 2024

So, even with growth and employment holding up better than anticipated, the progress with respect to attaining price stability has effectively led all major central banks to move to the sidelines and signal their intentions to move toward a less restrictive policy stance. A handful of central banks in EM and, more recently, DM regions have already begun easing cycles.

Except for Japan — where the economic and inflation backdrop did not compel the central bank to tighten policy with its peers — policymakers in major economies are expected to either cut rates further (European Central Bank and Bank of Canada) or make their first volleys (Bank of England and US Federal Reserve) in the coming months.

The pace of cuts, however, is unlikely to mirror those of the typical easing campaigns that come in the face of recession. Instead, the projected path looks to be more gradual and shallower, ending at levels more consistent with estimates of “neutral” (which typically range anywhere between 2% and 4%) rather than the “emergency” lows.

Central bank policy interest rates (percent)



Dashed lines represent overnight index swap (OIS) implied rates as at July 12, 2024; shaded regions represent periods of US recession; source: Guardian Capital using data from Bloomberg to July 12, 2024

While that suggests that policy easing would, therefore, result in a more modest degree of verve for the real economy than would otherwise be assumed, it still represents a material reduction in interest costs that would offer relief for borrowers and help push the net present value of delayed capital projects into positive territory.

Given that highly restrictive monetary policy and resultant tight credit conditions have long been viewed as key catalysts to a downward inflection in growth, that these pressures are anticipated to ease further in earnest in the coming months represents another favourable development for the outlook.

What's the risk?

The baseline outlook of broadening positive, if unspectacular, growth, moderating inflation, and declining interest rates is clearly positive and constructive for financial markets.

Unfortunately, however, those more pessimistic prospects of a potential “hard landing” that have weighed on confidence over the last few years cannot be completely eschewed quite yet. Growth and inflation trends have been favourable, but there is always the possibility that momentum could turn.

While there has been a clear disconnect between what consumers and businesses have been saying and what they have been doing in the post-pandemic era, it remains the case that measures of sentiment remain historically subdued.

Weak confidence about what is to come can become a self-fulfilling prophecy, where more conservative household and business spending decisions now weigh on demand and bring forward weakness that spurs softer job markets, which only exacerbate the ultimate hit to activity.

Further, the high cost of living is a big factor behind the downbeat assessment of current

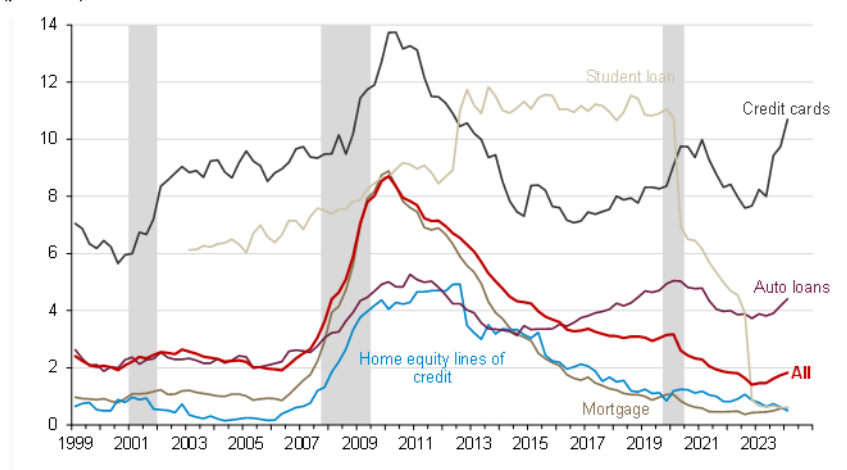
conditions. If inflationary pressures were to reassert themselves and erode purchasing power even more, that would constrain spending.

Persistently elevated inflation would also impede the ability of central banks to unwind the last two years' worth of aggressive policy tightening, likely resulting in interest rates remaining higher for longer than currently assumed.

There is already growing evidence of the long and variable lag of monetary policy being increasingly felt among households. Delinquency rates on US consumer loans have been rising in recent quarters with particularly sharp increases among credit cards.

Percent of loans 90+ days delinquent by type, US

(percent)



Shaded regions represent periods of US recession; source: Guardian Capital using data from the New York Federal Reserve Bank, Household Debt and Credit Report (Q1 2024), Economic Research, Data & Indicators. © 2024 Federal Reserve Bank of New York. Content from the New York Fed subject to the Terms of Use at [newyorkfed.org](https://www.newyorkfed.org)

That said, overall consumer loan delinquency rates remain benign, as households — that generally appear to be on solid footing against rising wealth and firm job markets — remain current on the housing-related debt that accounts for the vast majority of liabilities.

Even here, however, the prospect of interest rates persisting at high levels presents risk as mortgages increasingly come up for renewal and would-be sellers face less-than-ideal real estate market conditions — this is more of a near-term risk in Canada and Europe, where mortgage terms are considerably shorter than seen in the US.

Another key risk that appears set to intensify in the months ahead and increase the prospect of a more “exogenous” shock, stems from geopolitics.

The ongoing conflicts in Ukraine and the Middle East continue to take heavy humanitarian tolls on their respective regions and reverberate globally via commodity markets and rising uncertainty. The tensions around the Taiwan Strait continue to linger on the back burner as well.

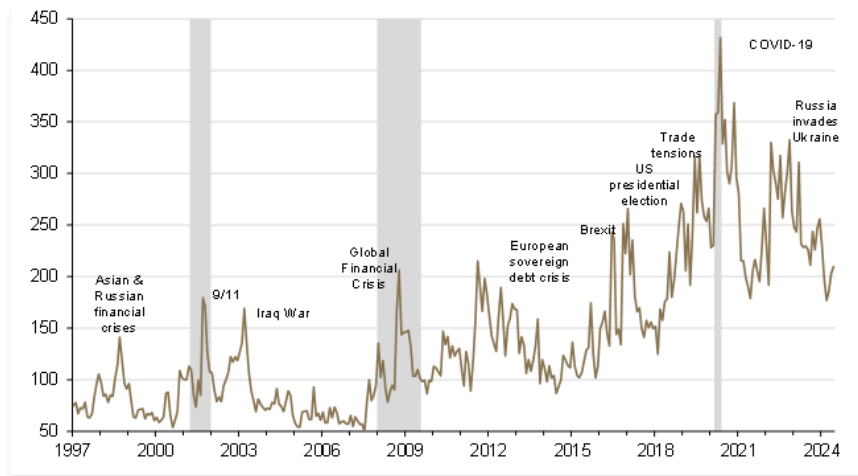
Relations between the US and China remain fraught. Recent tariffs imposed by the Americans focused on “clean” technology-related goods imported from the Middle Kingdom, will not ease

strains, while also creating an inflationary impulse. As well, the looming US election appears as though it will only likely add to economic frictions and increase the threat of added trade barriers.

Further, the uncertainty related to domestic policy stateside — and its global implications — has been ratcheted up in recent weeks against questions as to who will ultimately actually be facing off for the White House in four months, let alone the outcome of the vote. This just adds to the global policy tumult resulting from recent elections across Europe and Emerging Markets.

Policy Uncertainty Index, World

(index; pre-2015 average = 100)



Shaded regions represent periods of US recession; source: Guardian Capital based on data from PolicyUncertainty.com to June 2024

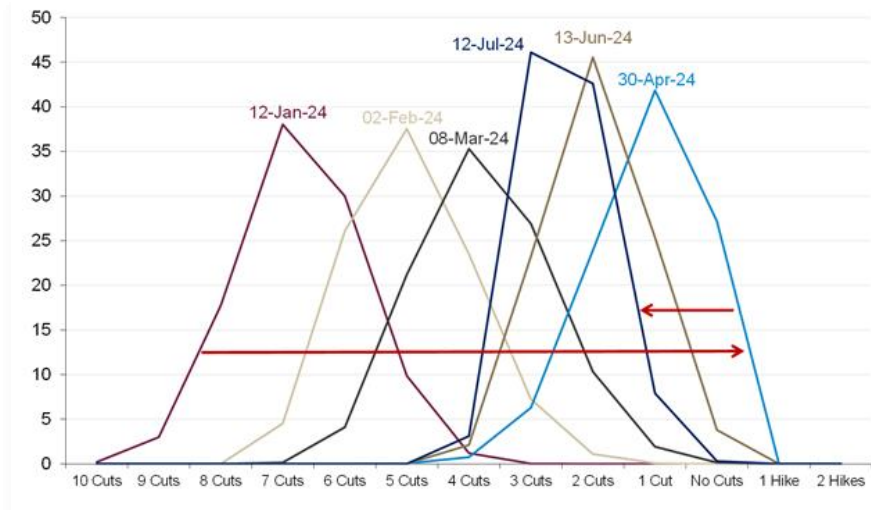
Bonded spirits

Lingering risks, combined with the prospect of further moderation in inflation and a policy-induced decline in interest rates, offer up a constructive outlook for fixed income investments that have endured among their worst three years on record.

That said, the very near term may see continued volatility until there is greater clarity on the policy rate path, especially with respect to the US Federal Reserve (the Fed) where expectations have undergone sizable swings over the last year.

Market-implied probabilities of US Federal Reserve policy path by year-end 2024

(percent)



Source: Guardian Capital based on data from CME Group, CME FedWatch Tool, July 30, 2024, <https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html>

Barring an unexpected material break higher in inflation that spurs, at least, the contemplation of further action from policymakers, however, it would appear that the peak in rates has likely passed.

The anticipated synchronized easing cycle from global central banks would exert downward pressure on rates, though, the more-policy sensitive front-end of the curve will likely see bigger declines and result in a steepening in the long-inverted yield curve.

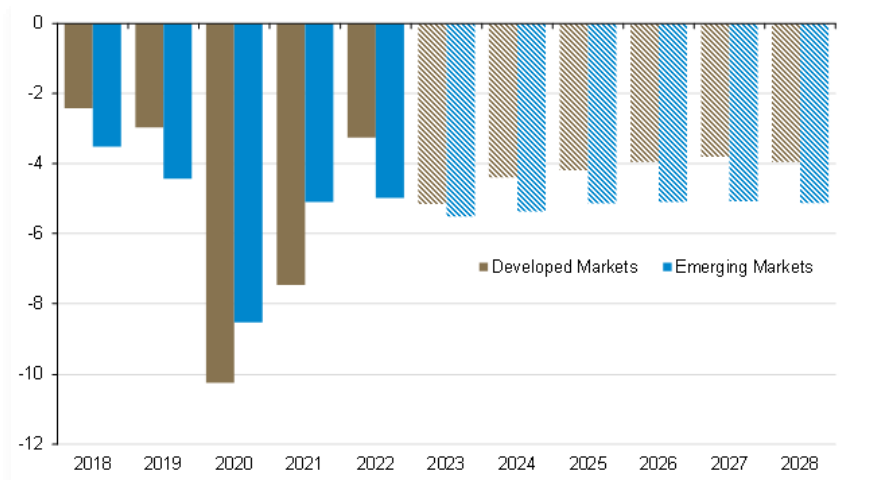
Further out on the curve, market forces will play more of a role than they have in recent history, and on that front, the expected supply/demand dynamics may keep longer-term rates more anchored.

Governments worldwide continue to express little appetite for reining in the still highly expansionary policies adopted in the aftermath of the pandemic that added to the inflationary thrust globally.

Budgetary shortfalls remain gaping and are not anticipated to improve any time soon as the heavy slate of elections this year and next (including in Canada) are not typically conducive to fiscal restraint.

General government fiscal balance

(percent of gross domestic product)

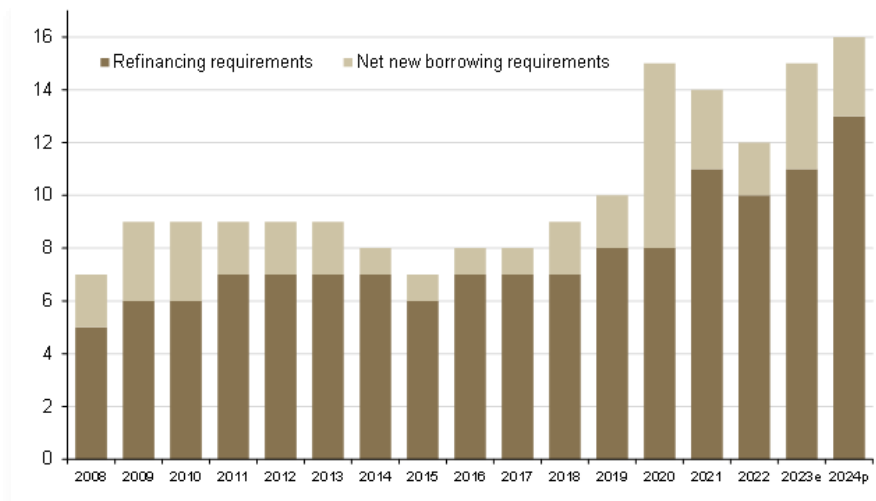


Forecasts are from the International Monetary Fund's April 2024 World Economic Outlook; source: Guardian Capital using data from the IMF

As a result, government debt loads are expected to continue growing at more onerous costs. Sovereign borrowing requirements across the economies that comprise the Organization for Economic Co-operation and Development (OECD) are slated to hit new highs and push the outstanding stock of government debt to records north of US\$50 trillion — the [2024 Federal Budget](#) indicated that Canadian gross bond issuance would top C\$500 for the current fiscal year.

Net sovereign borrowing requirements, OECD countries

(trillions of US dollars)

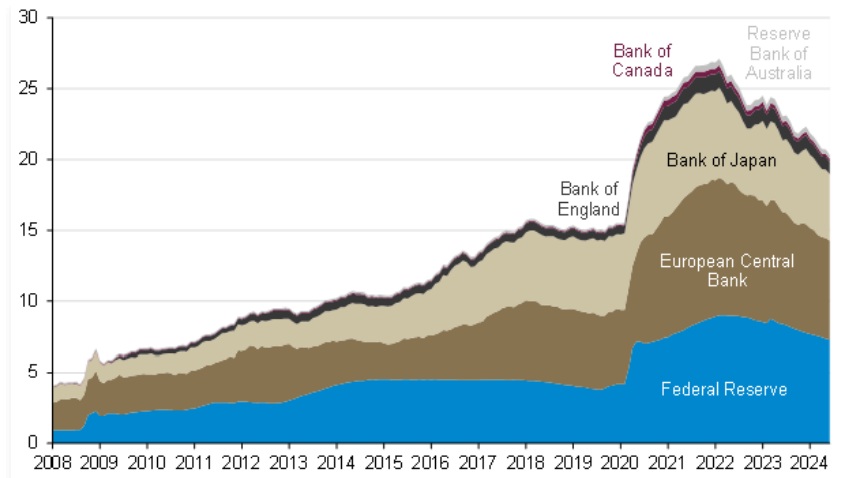


e="estimate"; p="projection"; source Guardian Capital using data from the OECD's Global Debt Report 2024 (March 2024)

Elevated government debt loads may not have represented an overly pressing concern in the world of zero interest rates and captive bond buying from price-insensitive central banks that prevailed over the last 15 years, but conditions have now changed. Central banks are no longer

active participants in markets, with major monetary authorities instead gradually scaling down the size of their historically bloated balance sheets.

Central bank asset holdings (trillions of US dollars)

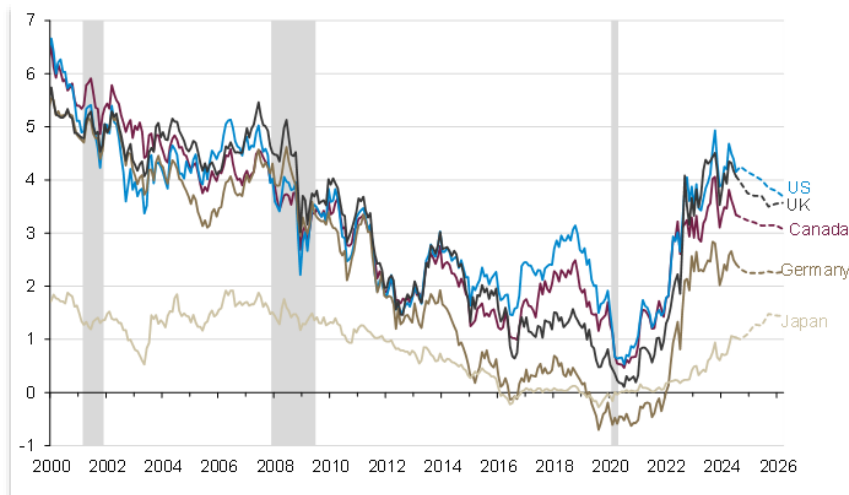


Source Guardian Capital using data from Bloomberg to June 30, 2024

The continued deluge of supply could face growing difficulties being absorbed in the more discriminating market, which could result in upward pressure on benchmark yields — which, in turn, would put added pressure on fiscal plans and provide a moderate headwind for growth.

As it stands, market consensus points to sovereign 10-year bond yields not deviating all that much from recent trading ranges over the forecast horizon.

10-year sovereign bond yield (percent)



Dashed lines represent consensus forecasts as at July 12, 2024; shaded regions represent periods of US recession; source: Guardian Capital using data from Bloomberg to July 12, 2024

That said, bonds would appear to provide a fairly compelling balance of risks trade-off that could continue to attract investor flows.

Yields remain around their highest levels in over a decade and the prospect of rates moving lower sets up for potential capital gains (due to the inverse relationship between interest rates and bond prices)¹ as well — and in the event of a material economic slowdown materializing (or even just rising risks), this latter feature would become more prominent.

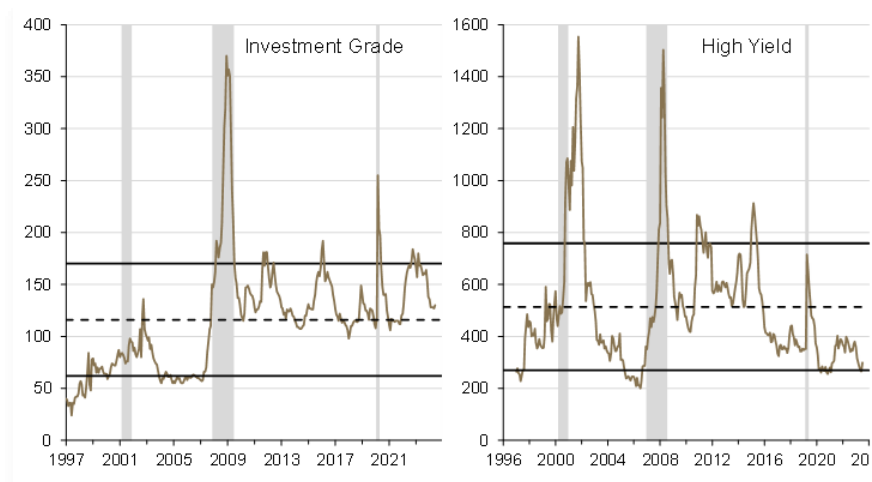
The fairly positive baseline economic outlook, however, would appear to argue in favour of bond exposures further out the risk spectrum

Corporate bonds offer comparably higher coupons that point to higher relative returns, while also offering a cushion against adverse market moves.

As well, the potential positives of reduced credit risk associated with the more sanguine baseline outlook could compound performance by a narrowing in spreads — high-investment grade credit appears to offer somewhat more scope for improvement on this front, while also providing the potential for a “safety” premium should markets turn for the worse.

Option-adjusted credit spreads*, Canada

(basis points)



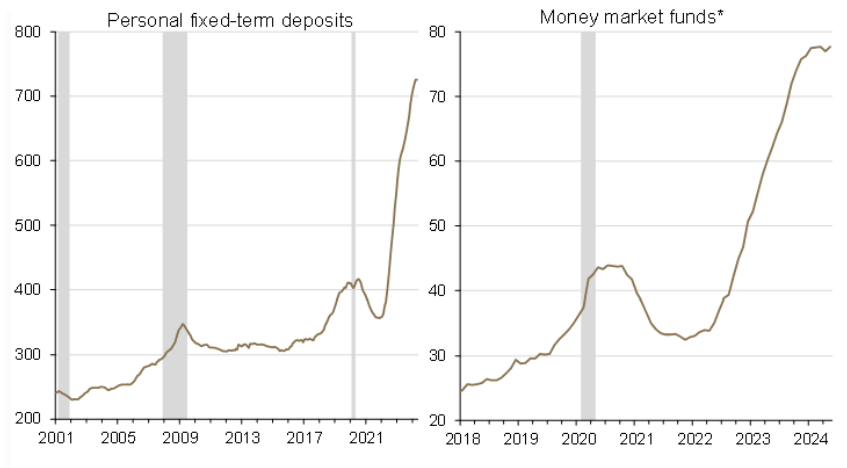
**ICE BofA Canadian Bond Indexes; dashed lines represent series averages, solid lines are +/-1 standard deviation from the average; shaded regions represent periods of US recession; source: Guardian Capital using data from Bloomberg to July 12, 2024*

Debt with shorter maturities continue to also offer a yield advantage over those issues with a longer duration, though, they stand to see lower capital gains benefits from a decline in rates given their lower duration. This short-term segment of fixed income markets is also likely to be subject to growing reinvestment risk as lower short-term rates make holding cash alternatives less attractive.

¹ Assuming bond purchase price is lower than its par value or selling price)

The prospect of a reallocation of even some of the almost C\$1 trillion in the fixed-term deposits and money market funds in Canada could serve as a tailwind to other, longer-duration assets.

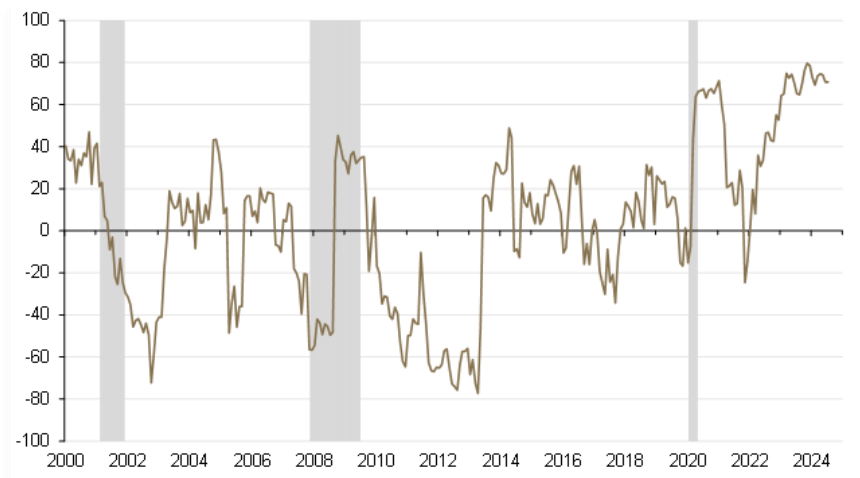
Fixed-term deposits and money market fund* net assets, Canada (billions of Canadian dollars)



*Domestic mutual funds and exchange-traded funds; shaded regions represent periods of US recession; source: Guardian Capital based on data from the Investment Funds Institute of Canada and the Bank of Canada to May 2024

The yields currently on offer and better longer-term return prospects with lower reinvestment risk make other fixed income assets (i.e., corporate bonds) attractive, particularly in a balanced portfolio context, where they serve as a counterbalance for equities, should the economic backdrop deteriorate and spur central banks into action, prompting a decoupling in the high correlation across these asset classes seen in recent years.

Stock* and bond** correlations, Canada (rolling 12-month correlation of total returns; percent)



*Stocks=S&P/TSX Composite Price Index; **bonds=FTSE Canada Universe Bond Index; shaded regions represent periods of US recession; source: Guardian Capital based on data from Bloomberg to July 12, 2024

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