Policy Odyssey

Notes from the Trading Desk - Q4 2024

RPIA

January 8, 2025

2024 was marked by slowing inflation and rate cuts, ending the year with the US Federal Reserve ("the Fed") cutting rates by 100 basis points and the Bank of Canada ("BoC") by 175 basis points. It was also hailed as the year of elections with 72 countries hitting the polls, including the US and France, which had a notable impact on global bond markets.

Although bond markets have priced in further rate cuts (currently one cut by the Fed in 2025), inflation could reaccelerate, especially when considering Trump's tariff agenda and potentially inflationary fiscal policies. Predicting the path of monetary policy is always challenging as investors analyze likelihood against impact while navigating volatility. One such example is the chance that a hike may still be on the table if inflation reignited drastically, but this is in no way our base case.

In Canada, the undeniably weaker economy has led to greater divergence from the US. As we face an impending trade negotiation with our largest trading partner, we are mindful of the impact of the upcoming Canadian election on bond markets, especially in light of our relatively weaker economy and Trump's very public negotiation tactics. We believe a Conservative majority in Canada may act as a modest tailwind to CAD credit and could allow the BoC to be even more aggressive regarding cuts, which has historically sparked massive inflows into Canadian credit products, resulting in CAD outperformance last year. However, the looming threat of tariffs complicates this further as the outcome of the trade talks could determine the level of inflationary risk for Canada and the subsequent BoC decisions.

2025 is kicking off with a strong supply of new bond issuance, higher long-term interest rates in light of a hawkish Fed, and materially lower yields in other geographies like Canada and Europe. From a positioning perspective, we are in a position to take advantage of opportunities in the US market over Canada while keeping an eye on European pricing for opportunistic and tactical trades.

Looking ahead, we believe this is a market where prudence is critical, focusing on capturing value through tactical trades where credit selection and active management are paramount to success. We aim to balance interest rate risk, credit risk, and volatility in the equity market that may impact bonds, with the expectation that uncertainty will persist as investors await the ripple effects of Trump's policies.

One example of credit selection is our Subway position in RP Select Opportunities, the fast-food sandwich chain that was recently taken private by Roark Capital, which issued a $2.3 billion BBB-rated secured bond in Q4, backed by their global royalties. At the beginning of Q4, credit spreads of Subway bonds were down, likely driven by market anticipation of a competitor's issuance of a similar bond despite Subway having robust credit protection in the bond documentation.

We saw this as an opportunistic entry point. Following the election-driven rally and the competitor issuing the bonds at tighter (more expensive) levels, we were able to capture value and decrease the size of our position, making Subway our top contributor in the strategy in terms of credit return.

Demand for bonds continues to be exceptionally strong, especially as trillions of dollars remain on the sidelines, seeking an entry point as central banks are easing. Our core view entering the year is that all-in yield remains top-of-mind, while the actual level of credit spreads is less so, fueling insatiable demand from yield-sensitive (i.e., pensions and insurance companies) and retail investors alike. We believe that we are in a higher-for-longer rate environment, which will continue to act as a tailwind for bond markets and support the outlook for fixed income.

For more updates on the credit market, read our **Credit Market Themes in 5 Charts** article for this quarter.

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