MACKENZIE
Investments

Fixed income report Q4 2024

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As 2025 resolutions follow 2024's reflections, we saw a momentous year in markets, continuous improvements in processes and the emergence of my favorite tradition as a team lead: our monthly book club.

We set aside the usual market talk and immerse ourselves in stories and ideas, sometimes they're finance-related, sometimes not, and see how those perspectives enrich our decision-making. For the first selection of 2025, my team has elected to read Thinking in Bets, the strategic masterclass from World Series of Poker champion, Annie Duke.

What strikes me most is how the author painstakingly explains this "unique" mindset of a professional poker player: assigning probabilities to every scenario, continuously adjusting those probabilities with new information, and never assuming complete certainty. It's true — there are few-to-no roles where the odds move as quickly as the cards are dealt, with each decision and the perception of each decision meaningfully shifting the outcome. However, despite this, there is perhaps no greater metaphor to how I have always approached investment decisions; neither as gambling, nor chance, but through a diligent analysis of the cards (markets) and the players tasked to observe them (investors). While unsurprising, I find it surprisingly validating. It's a reminder that our daily work in fixed income resembles a probability-based framework that many people think only applies to games of "random chance".

That framework is critical when so much of the market seems swayed by prevailing consensus, with players overly focused on their own hands rather than the newly dealt cards on the felt. Today, there is no better example than Canadian assets. Despite the widespread negativity on anything related to Canada, polls suggest the next election could deliver a majority to a degree not seen in over 40 years. The timing of the election remains uncertain, and polling numbers can certainly change; a mandate anywhere near projections offers

a high probability to meaningfully shift both policy and sentiment. Because even with an awe-inspiring pair of aces in your hand, however improbably, the board can always run out with a full house on the river.

I can think of no better reflection than the author's own tagline: "Making smarter decisions, when you don't have all the facts". By consistently revisiting our assumptions, we put ourselves in a position to spot and seize opportunities ahead of the crowd. That's the spirit of Thinking in Bets, and it's why we invest time in exploring ideas that push us beyond our usual thinking. In a world where even the simplest of outcomes are never guaranteed, the key to staying ahead is to remain agile, open to new information and ready to act when others least expect it. Whether in poker, portfolio construction or personal development, these tenets are paramount. As investors and lifelong learners, I can think of few greater goals as we seek to capture alpha and opportunities throughout 2025.

FIGURE 2: Mackenzie Fixed Income Team views

	Significant underweight	Underweight	Neutral	Overweight	Significant overweight
Duration			○		
CAD duration			○		
USD duration			○		
Euro duration			○		
JPY duration			○		
Credit				○	
Investment grade credit				○	
High yield corporate			○		
Leverage loan			○		
Private credit				○	
Inflation linked bonds				○	
Emerging market local debt				○	
Currencies				○	
USD				○	
Emerging market currencies				○	

○ Indicates no change

Source: Mackenzie Investments. As at December 31, 2024.

Macro commentary

Dustin Reid
Chief Fixed Income Strategist

Global yields, led by US Treasuries, moved generally one way – higher – throughout the fourth quarter, thanks to three key drivers:

- The increase in term premia.
- Expectations of continuing US economic exceptionalism.
- Trump's election and the so-called "Trump Trades" that ensued.

As a result, US 10-year yields were higher by almost 100 bps over the quarter, while the 2s-10s curve steepened by 28 bps.

Of the 100 bps (or so) increase in 10-year yields during the fourth-quarter, 60 bps or so could be attributed to the increase in term premia, rising from -10 bps to 50 bps. Term premia, in fixed income terms, is generally defined as "the additional return for holding long-term bonds versus short-term bonds due to the risks associated with longer maturities, such as interest rate risk and inflation risk." Perhaps a slightly less academic way of looking at term premia is to say "all of the things we cannot ascribe to growth plus inflation expectations over the next X years" gets thrown into the term premia bucket. Regardless, longer duration was not overly loved, with the market seeing the risks of US fiscal spending becoming even more unhinged under a Trump administration and the so-called "red sweep."

Exceptional US economic growth — and expectations of it continuing – meant markets needed to recalibrate yield levels from where they were late-September. Throughout the quarter we saw the final third-quarter and the fourth-quarter US GDP Forecast Now estimates continue to print almost stubbornly-high, especially versus other global economies. That in turn, also required markets to recalibrate Fed easing expectations for 2025. At the end of September 2024, markets were pricing an end-2025 Fed funds rate of 2.90%; by the end of the fourth quarter, that had risen to 3.90% — about the same relative increase as the 10-year yield over the quarter — with the market becoming ever more comfortable with the notion the US nominal neutral interest rate was materially higher than 3%.

Of course, we would be remiss if we did not speak about the impact of Trump's acceleration in the polls and to an even further extent in the betting markets in September and October, which clearly drove a number of "Trump trades" including the reflation trade (see yields above), the bullish equity trade (on the notion of faster nominal GDP, lower taxes and higher corporate earnings), and the long USD trade (repatriation, higher for

longer) — just to name a few. The threat, and potentially the imposition, of tariffs was a clear driver for Trump's anticipated 2.0 policy as November's election neared, as well as after the election. As we now know, the election was not as close as many people believed heading in, with Trump carrying all seven swing states, winning the popular vote, and Republicans winning both chambers of Congress (albeit narrowly). Trump's speech on election night served as a rallying cry given this mandate for sweeping changes and setting up for a flurry of cabinet and advisory nominations and appointees who would, presumably, tow and push Trump's hawkish line on tariffs, immigration, law and order, and deregulation.

As we turn the page in the early days of 2025 it appears a lot of those themes are poised to drive markets into the first-quarter and possibly beyond. Our view for a while would be tariffs, or the threat thereof, would lead the policy mantra and that indeed appears to still be the case, along with immigration and deregulation in both the financial and energy sectors. But the rise in yields from September is now getting to a point where any further increase could prove to be a hinderance on valuations for other asset classes (particularly higher beta assets) and the risk of a cross-asset correction looks more likely now than it did three months ago. We have long expected cross-asset volatility to increase and we are now at the point in the cycle where not only has that happened, but also further increases are more likely.

It goes without saying that Canadian assets are clearly at risk under the new Trump administration with talk of a "51st state" and "economic warfare" to achieve it. Canada's current political situation only amplifies the risk, not necessarily Trudeau in or out as PM, but prorogation of Parliament means all legislation — including the $1.3 billion border security bill that was cobbled together after Trudeau's visit with Trump in Florida late last year — essentially needs to be tabled again when parliament reconvenes. To us, this is a risk for tariffs being implemented, given the hawks advising Trump, and there is likely nothing to be done on the Canadian border security front until late-March at the earliest with parliament out.

Even a 10% across-the-board tariff on all Canadian goods imported into the US would have a significant impact on the Canadian economy — likely at least ~1% of real GDP during the first year. A 20-25% tariff implementation would clearly be recessionary in the best of times — and the Canadian economy is far from currently operating in the best of times. Market pricing for the Bank of Canada at 60 bps for 2025 (at time of writing) continues to look underpriced — as it has for a long while — and we would not be surprised if we saw the Bank's policy rate hit 2.25% or lower, or more than 100 bps from current pricing.

Rest-of-world tariffs are also very possible, especially if Trump and his administration decide to invoke the International Economic Emergency Powers Act (IEEPA), giving the President a virtual carte-blanche on imposing restrictions on imported goods and services. It struck us as odd that Trump "only" spoke about an additional 10% tariffs on Chinese goods over the current levels, with no major tariff commentary on Europe. The threat to increasing both, in our view, are more likely than not. Chinese officials have already been working to provide dovish forward guidance (more spending, easier monetary conditions) and US-China 10-year spreads are hovering around 300 bps. And with German economic data continuing to materially weaken, coupled with France's political malaise, the ECB finds itself in a spot where even the market's 100 bps priced for calendar 2025 might not be enough, even before Trump threatens or imposes tariffs on European good and autos.

With all the risks ahead for markets, 2025 might be one of the more challenging Fed calls in quite a while. As we go to print, current market pricing has 40 bps worth of easing for all of 2025, with the first 25 bps not fully priced until June's FOMC meeting. Indeed a "skip" at January's FOMC seems all but certain at this point, but beyond then the path is much murkier. December's FOMC meeting contained an interesting comment from Chairman Jerome Powell at the press conference, noting some participants had incorporated some of Trump's policy expectations into their forecasts, which is one of the reasons December's core personal consumption expenditures (PCE) inflation estimate for 2025 was significantly higher than market expectations. Given what we now know, it is likely more participants will add to these expectations for higher inflation and exceptional US growth from here and we may not see any Fed easing until the second half of the year. If correct, this will likely set up another showdown between Powell and Trump, with Trump pushing for lower rates, and Powell resisting — ironically as a result of the policies Trump himself instilled.

Global fixed income

Hadiza Djataou
Portfolio Manager

The Federal Reserve's evolving stance remains a key anchor for shaping expectations around global rates, particularly in the US. Anticipating the Fed's policy path is more complex in this cycle, with outcomes hinging on data-dependent decisions that are likely to sustain elevated rate volatility. Within global portfolios, US duration was underweight early in the quarter but was tactically increased as rates rose, reaching a neutral stance.

In the G10 space, German Bunds have demonstrated notable resilience, diverging sharply from US Treasuries and avoiding the recent surge in yields. This divergence reflects a significantly different fiscal and economic backdrop, along with more supportive technicals. Fundamentally, the euro zone outlook remains subdued, with tariff risks compounding existing challenges. The ECB's easing path — with 95 bps of cuts anticipated for the full year 2025 at the time of writing — is largely priced in. Tactical additions to euro zone duration were made in global portfolios over the quarter but balanced with an overall underweight stance, given the prevailing upward trend in global yields.

Japan remains a market where upward pressure on yields is expected to persist, driven by the gradual normalization of monetary policy. Japanese government bonds continue to be a strategic underweight, reflecting expectations of incremental but steady policy adjustments.

Most overweight duration positions in G10 rates are currently allocated outside the euro zone and the US. New Zealand is favoured for its compelling real yields, while Canada is attractive due to its rapidly deteriorating economic outlook, which could justify lower policy rates. A steepening bias is maintained globally, supported by expectations of continued central bank easing combined with rising term premiums. The latter is likely to result from ongoing central bank balance sheet reductions, heightened fiscal and issuance uncertainty, and structurally higher inflation dynamics compared to the 2010–2020 period.

Core inflation has broadly declined across developed markets, though the pace of disinflation in the US has recently slowed, underscoring the challenges of achieving central bank targets. US wage growth continues to moderate, which should exert downward pressure on services inflation, excluding housing. Additionally, indicators of new tenant rents suggest

further deceleration in CPI rental inflation through 2025. However, tariff risks remain a key upside factor for US core inflation, with the potential to drive prices for goods higher. While tariffs are typically considered one-off price shocks, the risk of more persistent inflationary effects is amplified by current fiscal and immigration policy frameworks.

In the euro zone, disinflation has become somewhat less challenging. Forward-looking wage data and job postings suggest that elevated wage growth in certain regions will begin to moderate. However, tariff-related risks could intensify concerns about inflation undershooting the European Central Bank's (ECB) 2% target in 2025 or beyond. In other developed markets, inflationary pressures remain persistent in Japan, sticky in the UK and stubbornly high in Australia. Across emerging markets, disinflation momentum has stalled in several regions, including Latin America and Central and Eastern Europe, while remaining subdued in Asia, particularly in China. Inflation-linked instruments, particularly US TIPS — which remain a key allocation of the global portfolios — continue to offer attractive real yields, reflecting the view that inflation is structurally higher than in previous cycles.

Emerging market currencies remain closely aligned with the trajectory of the US dollar. Post-election developments in the US have introduced new policy uncertainties, including tariff threats and unconventional cabinet appointments. These factors, along with fading expectations for aggressive Fed easing and weakening growth prospects in Europe and China, have widened policy rate differentials and strengthened the US dollar, pressuring emerging market currencies.

Latin America has come under renewed investor scrutiny this quarter. Brazil's appeal has diminished due to rising inflationary pressures and political instability, while Mexico's outlook has been dampened by domestic political uncertainties, falling oil prices, and potential shifts in US trade and immigration policies. Both countries, once market favourites, now carry elevated risk premiums that are unlikely to ease in the near term, in our view.

Conversely, Indonesia's local government bonds and South African debt remain relatively attractive. Indonesia offers higher yields, while South Africa benefits from an advanced disinflation process that strengthens the South African Reserve Bank's capacity to ease policy.

Over the quarter, exposure to EMFX was reduced to mitigate risks associated with a stronger US dollar, higher global rates, volatile market sentiment and extreme positioning in certain markets.

Outlook

We expect global rates to remain volatile, driven by divergent central bank policies and evolving fiscal dynamics while creating opportunities. Risks are likely skewed toward a stronger US dollar, rising global rates and persistent inflation uncertainty. These dynamics warrant a selective and tactical approach to duration and risk allocation.

Canadian investment grade fixed income

Mark Hamlin
Portfolio Manager

Felix Wong
Portfolio Manager

Unsurprisingly, US political events were the primary focus for fixed income markets during the fourth quarter of 2024.

Despite a surge in excitement in favour of Kamala Harris after President Biden stood aside earlier in the year, polling, and particularly betting markets, moved more in favour of a Trump/Republican win as the year rolled on, correctly predicting the outcome of the early November election. Markets moved in lockstep, aiming to decipher what a Trump win and possible Republican sweep would mean. The two policies that markets are most focused on (and concerned about) are deficit spending and tariffs.

The concerns over unfunded tax cuts drove yields higher led by the back end of the curve — steepening the curve marginally in the process. Five-year, 10-year and 30-year UST rose 87.2 bps, 83.8 bps and 71 bps, respectively, whereas 2-year UST rose 62.8 bps. Tariff concerns were most evident in currency markets with the USD performing well, particularly against currencies most at risk of the most substantial tariffs — Mexico and Canada.

Despite higher bond yields, equities continued to perform extremely well in anticipation of continued interest rate cuts by the US Federal Reserve. That ended in December, when the Fed cut interest rates by 25 bps as expected, but telegraphed to the market that progress on inflation appeared to be stalling and further rate cuts would be dependant upon data. This unwelcome news caused a significant spike in cross asset volatility and a selloff in risk assets, led by equities.

Canadian markets usually take their lead from their US counterparts and divergence is rare, but the two economies remain in different situations and probably on very differing paths in the short term. While longer end yields in Canada were dragged somewhat higher by US yields (5s, 10s and 30s in Canada rose 22bps, 28bps and 21bps, respectively), 2-year yields were essentially unchanged. This despite the Bank of Canada continuing with its rate cutting cycle, with 50 bps reductions on October 23 and December 11. This left the policy rate at 3.25%, another negative for the Canadian dollar. At its December meeting the Bank did signal that these jumbo rate cuts are likely over. In reality that will depend upon economic actions by the US once the new administration is in place.

Changing rate and equity volumes during Q4/24 have not affected North American corporate bond market, with corporate spread continuing its slow grind narrower, closing into the tightest level since credit crisis. The US and Canada corporate spread came in by about 7 bps and 16 bps respectively last quarter, and by about 16 bps and 33 bps for the year. Positive risk sentiment because of policy rate cuts by the central banks and positive funds flow into the fixed income market continues to drive the rally in spread, despite strong new corporate issuance in Q4/24. The rise in yields last quarter have led to negative total return in investment grade market. The FTSE Bond Universe Index returned -0.04%, whereas the US Aggregate Bond Index returned -3.06%.

Outlook

Politics remain front and center with the new US administration taking power in late January and threatening to implement 25% tariffs. Any tariff would of course be problematic for Canada. Retaliatory action would be inflationary and any support by the Bank of Canada via increased rate cuts would weaken the currency and be inflationary. The path of longer end rates remains especially uncertain. The yields on 30-year Canadian bonds are now 150 bps lower than 30-year US yields. Any increase in inflation would make the sector relatively unattractive to own, although all yields usually trade lower during a cutting cycle. It is unclear how attractive investing in Canada would be if it is in the midst of a prolonged trade war with its biggest trading partner.

An additional effect of tariffs could be on Canadian credit spreads. Credit remains well bid, although marginally off the tights. At current valuation, we consider the corporate bond market expensive, although the current positive fund flows and higher yields may lend support to prolong this richness a little longer. Given this, and until there is more clarity on the geopolitical situation between Canada and the US, we see no reason to increase credit holdings and would look to improve credit quality and liquidity.

High yield corporate fixed income

Dan Cooper
Head of Credit,
Portfolio Manager

Ken Yip
Portfolio Manager

The US high yield bond market returned 0.16% in the fourth quarter of 2024, bringing the full year total return to 8.20%.

The story of the year was CCCs which, after a rough start of 2024, returned another 2.45% in the fourth quarter bringing their full year total return to 18.18%, driven largely by M&A activity in the cable and telecom sectors. The new issue market saw a massive uptick in 2024 due to this robust backdrop for high yield, with gross primary activity up 64% year-over-year from $176.1 billion in 2023 to $288.2 billion in 2024, of which $48.5 billion was in the fourth quarter.

The current high yield market spread of 292 bps is pricing in expectations of a continued rate-cutting cycle and the forward-looking excitement of a business-friendly environment under Trump's second administration. The continuation of the rate-cutting cycle that delivered 100 bps of cuts in 2024 is now in question for 2025, and if those rate cuts don't materialize, spreads may widen (and yields rise) due to the impact of "higher for longer" that could weigh on the economy and potentially result in a weak economic backdrop. With that being said, the yield-to-maturity of 7.47% for the high yield market does look attractive relative to historical yields we've seen for the better part of the last decade, although still lower than other areas of leveraged credit such as leveraged loans and private credit. The total return opportunity thus remains compelling for high yield from a carry perspective under the pro-growth environment that we expect to be in place for the next few years.

High yield bonds are also supported by the following factors:

- The yield on the high yield market has risen from the low of 4.3% on December 31, 2021, to 7.47% on December 31, 2024. The current yield represents an attractive source of income after a long period of low yields (and even negative yields in some areas of the market), with a more significant buffer from rising rates than provided by other areas of fixed income.
- The average price of a high yield bond has declined from $103.31 in 2022 to a current price of $95.48. The majority of these bonds will continue to make their coupon payments and mature in the future at a price of $100, representing an attractive capital gain opportunity for investors who are willing and able to do the deeper analysis required in the high yield market.
- The overall quality of the issuers in the index is higher than at almost any other time in history, with over 50% rated BB, as a large portion of the index is represented by fallen angels — companies that were previously investment grade before being downgraded to the high yield market.
- The high yield market issuer fundamentals are strong, as companies were able to refinance debt and extend out maturities at attractive yield levels prior to the beginning of the rate-hiking cycle. With reasonable leverage and record high interest coverage ratios, we see limited risks related to covenants, liquidity or refinancing needs for the majority of the index.
- The high yield default rate last peaked in 2020 at 6.8% and traded as low as 1% in the post-covid period. The default rate has since increased from those record lows and currently sits at 1.5%, as the stress caused by the rate-hiking cycle has moderated as the Fed has shifted to a rate-cutting cycle. We do expect defaults to increase from these historically low levels but stay well below prior cycle peaks, given the relatively short time frame since the last default wave, the high quality of the index and the strong overall fundamentals of the issuers.

Following the Trump election win, the markets moved significantly higher on improved sentiment, with excitement related to deregulation, extension of tax cuts and the pro-growth/pro-business backdrop. These views have since moderated, as concerns grow regarding the path of future interest rates cuts by the Federal Reserve. These concerns have created volatility and weakness into the end of the year.

Outlook

In a stable/falling interest rate environment, the 7.47% yield in high yield is a compelling investment. As such, our team will be monitoring the trajectory of the interest rates, as we believe sentiment might shift negative in a scenario of yields on the 10-year US government bond rising over 5%. Returns for high yield will be highly correlated to duration moves and spreads of 292 basis points are at risk of widening if this negative sentiment doesn't moderate.

Higher yields and rising spreads would create a particularly difficult backdrop for highly leveraged companies that still need to complete refinancing transactions or raise liquidity. As a result, our team preference is for higher-quality high yield exposure and we are positioned accordingly with a growing weighting to the BB and BBB-rated category.

We're also finding attractive opportunities in other areas of the fixed income market that we feel may offer attractive risk-return characteristic and diversification opportunities for our mandates such as; private credit, the US cannabis debt market and the hybrid and limited recourse capital note (LRCN) markets.

We do expect that credit selection will grow in importance through the year and an increased focus on corporate earnings and fundamentals at these tighter spread levels and end of cycle conditions. Given the uncertainties that continue to loom over the market in terms of geopolitical risks, election risks, interest rate risks and whether the economy will achieve a soft-landing, we do expect to see higher levels of volatility, which we hope to capitalize on in our mandates.

Leveraged loans

Movin Mokbel
Portfolio Manager

In Q4, loans stood out positively as most fixed income asset classes struggled. Loans consistently delivered positive quarterly and monthly returns throughout 2024.

The relatively high loan carry, which sometimes offset small price declines, resulted in a decent quarterly return and the twelfth consecutive positive monthly return for loans. Notably, loan yields have decreased by more than 150 bps since the end of 2023 due to three Federal Reserve cuts and record repricings, leading to lower loan spreads.

For 2024, loans performed extremely well on a risk-adjusted basis, with a +8.95% return, compared to +8.20% for high yield bonds, +2.76% for investment grade corporates and -1.69% for 10-year Treasuries. The performance of loans continues to be driven by high coupons, no rate risk and very strong technicals, mostly driven by new collateralized loan obligation (CLO) formation, strong retail inflows and low new issue. Loan market fundamentals are a double-edged sword: leverage ratios have been decent and improving, but coverage ratios, especially for CCC and some B- issuers, are stressed, leading to cycle record high default activity through Liability Management Exercises (LMEs).

A healthy demand for loans persisted throughout Q4, driven by strong demand from new CLO formations and retail inflows, despite a general risk-off sentiment in the markets in December following the Fed rate cut. The quarterly return was still driven by high coupons, with the three-month term secured overnight financing rate (SOFR) hovering around 4.3% after the Fed cuts in September, November and December. Technicals remained very strong throughout Q4 due to little new net supply from new issues in the primary market. The primary market was robust in Q4, focusing on repricings and refinancings.

Loans continue to offer good relative value as they provide higher current yields than HYBs, reflecting the lower quality of the loan market compared to the high

yield market and the still high benchmark SOFR. The credit quality difference between loans and HYBs is shrinking due to improving credit quality in the loan market, resulting from light issuance of aggressive leveraged buyouts (LBOs) in the past two years.

In 2024, 38 companies conducted LMEs, compared to 21 in 2023 and only nine in 2022. The Chapter 11 LTM default rate finished Q4 at 0.91% by principal amount and 1.45% by the number of borrowers, essentially unchanged from November. This default rate excludes all LMEs, which have become more common than Chapter 11 filings. Recoveries in the loan market have reached record lows due to the preponderance of LMEs in distressed credits, the shifting composition of the loan market to more asset-light sectors, the lack of subordination with loan-only debt capital structures, and the prevalence of covenant-light and loose documentation in the loan market to fund LBOs before 2023.

Outlook

Looking ahead to 2025, loans present an attractive return opportunity given their 8.5% yield and below 98 price, with no direct rate risk. Markets were previously pricing in aggressive rate cuts before Q4, and as these expectations moderated, rates jumped, and bond yields widened substantially. Now, with more realistic rate cut expectations, loans are again an attractive alternative to continue collecting above-average yields. Rate cuts are not necessarily negative for loans; if cuts stimulate the economy and fuel risky assets higher, loans will generally follow.

From a macro perspective, there is a consensus for a growth scenario after the significant Trump win in the US elections, which will be constructive for credit, including returns for loans. Over the past three years, loans have outperformed on a risk-adjusted basis due to high rates providing high single-digit or double-digit coupons and a still-performing economy with strong employment. Defaults in the loan market have been rising, but if the macro backdrop does not result in significantly more defaults, loans are likely to continue performing well. If higher rates lead to a hard landing, loans may underperform. Overall, absent significant deterioration in credit fundamentals, loans remain attractive with an 8.5% yield. Most default candidates are already marked down in price, easing losses from actual defaults when they occur. Macro risks, such as inflation, geopolitics, trade wars, and potentially easing consumer and corporate demand, remain relevant but have somewhat abated.

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