Portfolio Management

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Fixed Income Strategy

3% Treasury Yields – Why Now?

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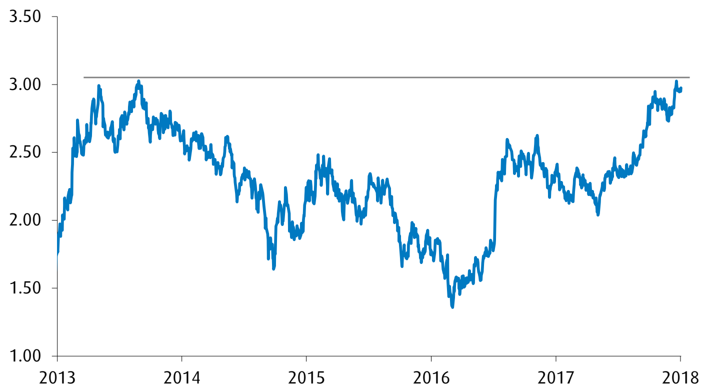
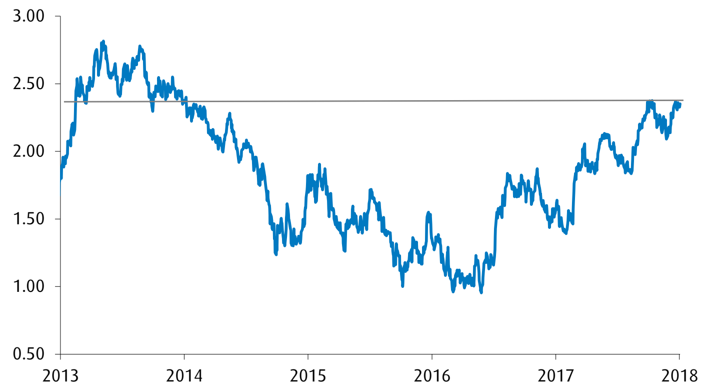
The U.S. treasury 10-year yield was again one of the main stories in April as it briefly crossed paths with the 3% mark, reigniting all fears of a major breakdown in fixed income markets. Even the Canada 10-year yields flirted with a 4-year high (range 2.35-2.40%) on the back of stronger inflation in Q1. The concern is real and hasn't been that widespread since the 2013 run-up in yields as central banks' policies and inflation trajectory seem supportive of the upward trend.

Figure 1: U.S. Treasury 10 Year Yield – About to Break Out



Source: Bloomberg

Figure 2: Government of Canada 10 Year Yield – About to Break Out

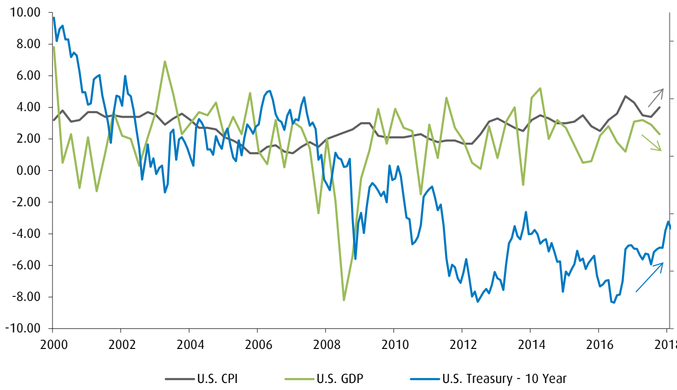


Source: Bloomberg

Lately, we discussed ad nauseam all the factors that we believe are supportive of higher rates. This has been a story in the making for a while, so why higher rates *now*? In fact, why has it not happened earlier this year as highly anticipated? The combination of better economic forecasts, strong corporate earnings, record quarterly U.S. treasury issuances and interestingly the cycle-high short interest in treasury bonds and futures could not even push 10-year yields above 3%. Not even the glimpse of hope for the Korean peninsula could lead yields on safe assets higher.

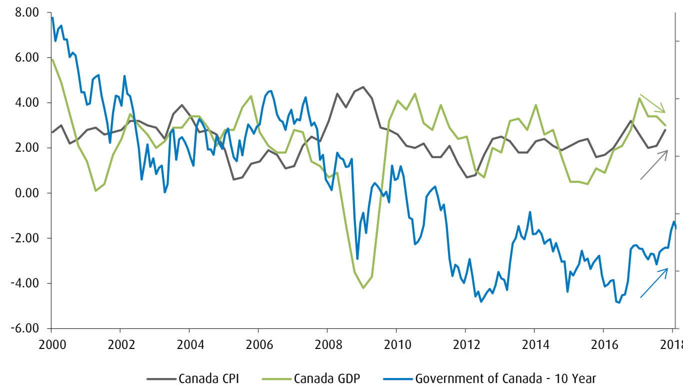
Arguably, U.S. treasury yields may have found some support from the equity pullback and the rise in volatility. It may also have been supported by foreign demand as yield spreads between European and U.S. government bonds reached their widest level in years.

Figure 3: U.S. Growth and Inflation Compared to 10-Year Yield



Source: Bloomberg

Figure 4: Canada Growth and Inflation Compared to 10-Year Yield



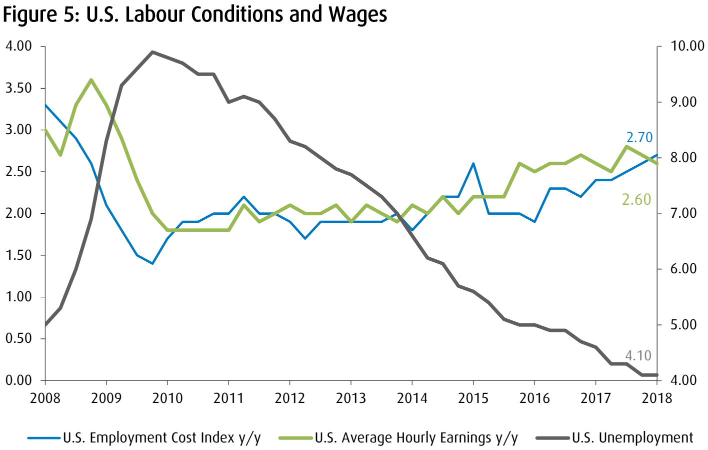
Source: Bloomberg

Yields also struggled to move above 3% perhaps due to a slight shift in sentiment about global economic growth from optimism to caution. With signs that North American and European economic growth have decelerated, along with slower job growth, it is becoming more difficult to find a catalyst that would push the 10 year yield even higher. The lack of a catalyst seems to be partly responsible for the more muted response in long term yields, leaving the yield curve to continue flattening despite signs of rising inflation.

To extend from a 2-year to a 10-year bond, an investor gets compensated an additional 45 basis points (bps) or 0.45%, approximately, in the U.S. (relatively similar in Canada). The compensation is even worse at the longer end of the curve. To extend from a 10-year to a 30-year bond, an investor gets compensated an additional 1 bp per year or 20 bps in total for the additional 20 years of term risk (less than 10 bps in Canada). These are some of the smallest yield compensations since the financial crisis and it could soon lead to an inversion of the yield curve, potentially a symptom of economic growth decelerating further. While we believe it would be a bit early to forecast an inversion, let alone a recession, we admit that the short-term outlook may have been a bit clouded.

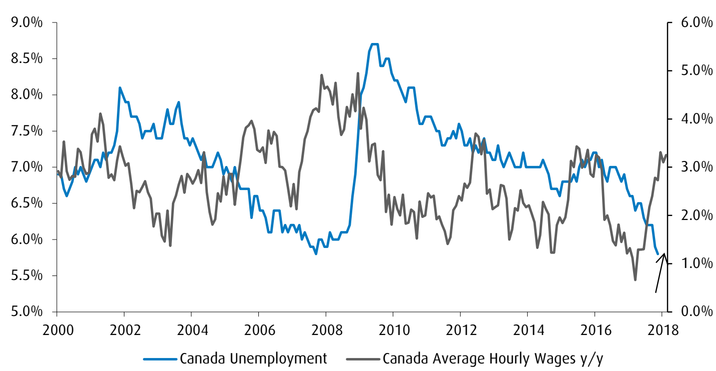
In our opinion, this should not yet deter the Federal Reserve (the Fed) and the Bank of Canada (BoC) from preemptively tightening policy as the counter arguments to growth are the wage gains and inflation that have undeniably been on a rising path. The wage growth and inflation alone support further tightening.

Figure 5: U.S. Labour Conditions and Wages



Source: Bloomberg

Figure 6: Canada Labour Conditions and Wages



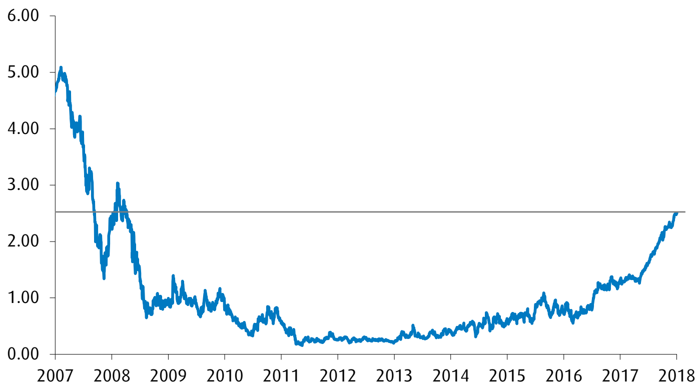
Source: Bloomberg

Wage gains and inflation could also be late cycle indicators, putting into question whether the aggressive policy expectations for 2018 and 2019 are still warranted despite central banks' softer growth and inflation forecasts. While the focus remains on central banks targeting higher neutral rates, recent economic data seems to be gradually weakening the case for tighter policies. We have yet to be convinced of the need to be as aggressive for the remainder of the year if only for the fact that real short term rates remain negative, a very stimulative policy that is more difficult to justify in this current economic environment.

This brings us back to the over-publicized 3% yield on 10-year treasuries. For some, this is another number, a technical level that may be breached soon, and for others, the break higher marks a more significant event, the end of the bond bull market. For many, however, it is not about whether it will trade higher or lower, but whether it will be representative of the economic trajectory.

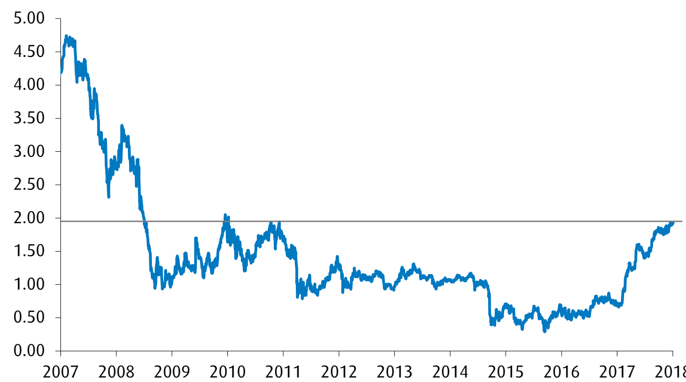
Unfortunately for investors, the focus has been on longer term rates when the bigger story has been unfolding in the short term sector. Over the last year, 2-year U.S. treasury and government of Canada yields have more than doubled, reaching their highest levels in 10 years as the central banks raised rates. This is a trend that may continue as inflation may force central banks further on the tightening path.

Figure 7: U.S. Treasury 2-Year Yield



Source: Bloomberg

Figure 8: Government of Canada 2-Year Yield



Source: Bloomberg

Why is this important? It means that despite lower allocations to longer term securities to reduce interest rate sensitivities, fixed income portfolios have continued to underperform, especially in recent quarters. What further exacerbated the issue is the fact that unlike pension funds and insurance companies that tend to be long term in nature, private investors have favored shorter maturities, rarely exceeding 10 years to maturity.

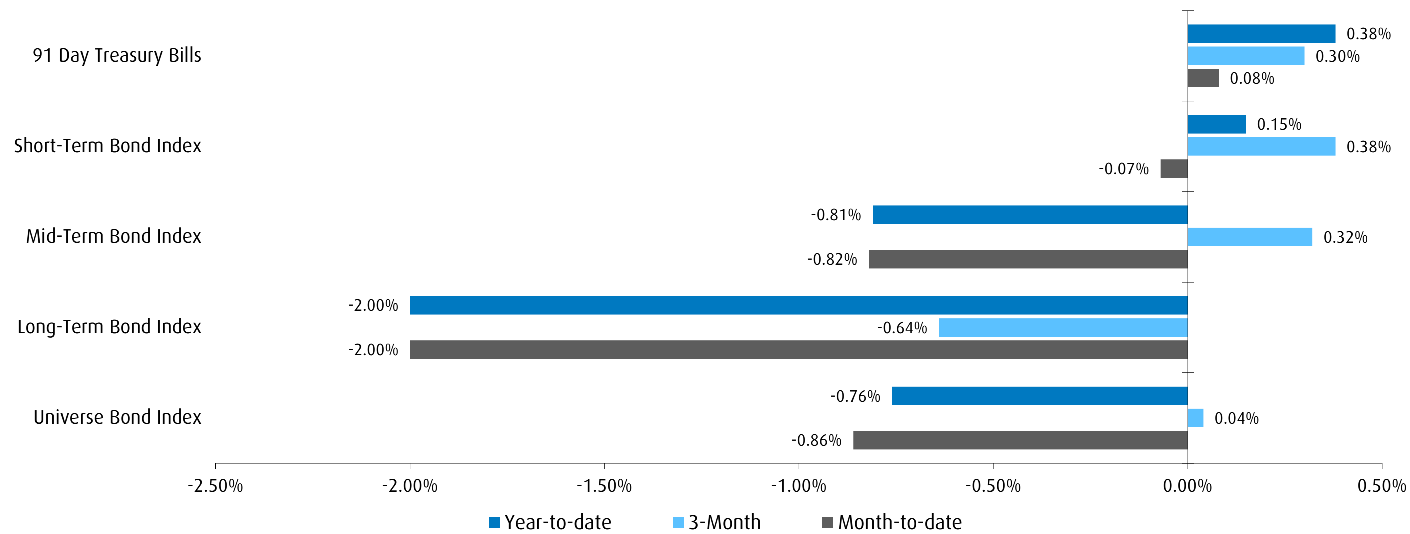
Before thinking about selling your fixed income investments as part of your capital preservation strategy, it is important to put things in perspective. As investors we need to understand the difference between losses from price variation and default. While the former is market-based and normal in a rising interest rate environment, it does not result in an actual loss like a default if the security is held until maturity. Price erosion from rising interest rates only serve as shifting greater cash flow distribution in the later years of the life of a bond as the expected yield is rising. A default, however, is the result of an issuer no longer able to service the debt and/or repay the loan at maturity, leaving investors with unrecoverable losses. Fortunately, corporate credit markets have remained strong and default rates are low.

Having said that, we cannot deny the angst that comes with seeing the erosion of the principal value of fixed income investments. Unfortunately, as investors we haven't been accustomed to negative returns in the multi-decade bull market. But let's remember that fixed income investors tend to be long-term in nature. Even if a security has lost value in the wake of the recent rise in rates, we continue to expect to receive the regular coupon payments and our principal unless the credit quality of the investment has deteriorated. Rising interest rates will always remain a short-term concern for investors, but long term investors will move beyond short-term price variation and welcome higher yields (finally).

From a reinvestment perspective, we think this is a *good* thing as we look forward to both income and maturities to benefit from higher yielding investments. This may not yet be the case for longer term securities but we are now seeing more attractive short-term Guaranteed Investment Certificates rates and more importantly better opportunities in the provincial, municipal and corporate bond sectors with a 3 to 5 year term to maturity. This is where investors stand to gain the most as yields often exceed cash and cash equivalent rates by over 100 bps.

Research from BMO Global Asset Management found that 60% of the total return of bonds during the bond bull market was the result of declining yields and price appreciation but more interestingly it found that coupon income contributed over 1500%. Central banks may continue to tighten, inflation may rise further and the 10-year U.S. treasury yield may rise above 3%, causing further price volatility. However, this should not change the importance for fixed income investors to remain invested and continue to earn their coupons.

Figure 9: FTSE TMX Universe Bond Index Returns (for the period ended April 30, 2018)



Source: FTSE-TMX

General Disclosure