Bonds are back

How to approach the current bond market

After nearly a decade of near-zero interest rates that eclipsed the benefits of bonds, the tide has shifted for this important asset class.

This material is intended for advisors and investment professionals.

Background

Over the past two years, amid surging inflation and central bank rate hikes, the important role of bonds and fixed income funds as a ballast to a diversified portfolio and a source of yield has been reprised.

Bond investors are finally getting rewarded as we move from a borrower's bond market to an investor's market. From those looking to balance out their investments to those nearing or in retirement, bonds have re-entered the spotlight as a central return generator. Once again, bonds can provide an effective way to help diversify portfolios by providing a less risky alternative to equities, along with a steady income stream.

The period ahead should provide opportunity across different parts of the yield curve and across different bond asset classes. Active management plays an important role as bond managers maximize the opportunities in strategic parts of the yield curve – such as the front-end, where yields are currently highest.

This means bond funds are back in the game, providing a strong counterpoint to other asset classes – offering stability, growth potential and essential diversification for their long-term investment journey. Currently, we're seeing short-term yields higher than what we've experienced in the past decade. If interest rates decline there could be an opportunity for some capital appreciation.

The bigger picture

Bonds are at an inflection point

Today, bonds are at an inflection point and the outlook is positive.

> Signs of easing inflation and economic challenges indicate policymakers in the U.S. and Canada could ease their monetary policy. The Bank of Canada (BoC) has signalled the potential to cut rates in 2024, although the jury is out regarding the timing, degree and pace of easing. The U.S. Federal Reserve (Fed) has signalled they may hold interest rates at their current level if inflation continues to run above the central bank's 2% goal.

With the economy still cooling and the threat of a weaker outlook ahead, the European Central Bank (ECB) appears more tentative with its rate cuts. However, indications are the bank might begin to consider interest rate reductions as early as June. Amid an uncertain economic outlook and the potential for rate cuts, bond managers are exploring beyond the long end of the yield curve, with long duration assets and sovereigns benefiting from the near-term uncertainty in Europe.

The pausing and cutting of central bank rate hikes have tended to be positive for bonds. Rate cuts could provide a healthy tailwind of price appreciation for bonds, providing a source of opportunity to enhance overall total return. Total return refers to all the gains bonds can deliver, including interest income from their coupons as well as capital appreciation (or depreciation) of their price over time.

Periods following central bank rate cuts historically positive for bonds

When U.S. and Canadian central banks have cut interest rates, bonds have historically delivered relatively strong returns.

	December 2000 - June 2003	September 2007 - December 2008	July 2019 - March 2020
Fed rate cuts	6.50% - 1.00%	5.25% - 0.25%	2.50% - 0.25%
U.S. bonds performance*	9.07%	8.15%	8.41%

*Index: U.S. bonds represented by FTSE U.S. Broad Investment-Grade Bond Index Total Return $US

	November 2007 - September 2009	March 2020 - April 2020
BoC rate cuts	4.50% - 0.25%	1.75% - 0.25%
Canadian bonds performance*	6.91%	3.79%

*Index: FTSE Canada Universe Bond Index Total Return.
Source: Morningstar

88-7142

While yields dropped sharply during the global pandemic, they've since reversed course. In the first quarter of 2024, Canadian and U.S. bond yields nearly reached levels not seen since before the 2008-09 financial crisis[1]. At present, there's an opportunity for yield seekers as well as those seeking to invest at higher yields.

1 Based on average yield of Canadian bonds, as represented by the FTSE Canada Universe Bond Index, and of U.S. bonds, as represented by the FTSE U.S. Broad Investment-Grade Bond Index

> "The return from bonds comes from both income and price change. Returns are not symmetrical due to the income that bonds provide. The opportunity now is to see price appreciation, but we're also in a strong position to weather an increase in interest rates given the strong level of yield, which has moved up significantly."

Janet Salter, VP and Portfolio Manager at Portfolio Solutions Group, a division of Canada Life Investment Management Ltd.

Reversing an inverted yield curve: A historic opportunity

> "For portfolios positioned on the front end of the yield curve, there's an opportunity for bonds to outperform if we see rates decline."
>
> – Janet Salter
>
> VP and Portfolio Manager at Portfolio Solutions Group, a division of Canada Life Investment Management Ltd.

An easier monetary policy climate has historically been good news for bonds. So, as the current inverted yield curve reverses course and begins to normalize, it should provide further opportunity.

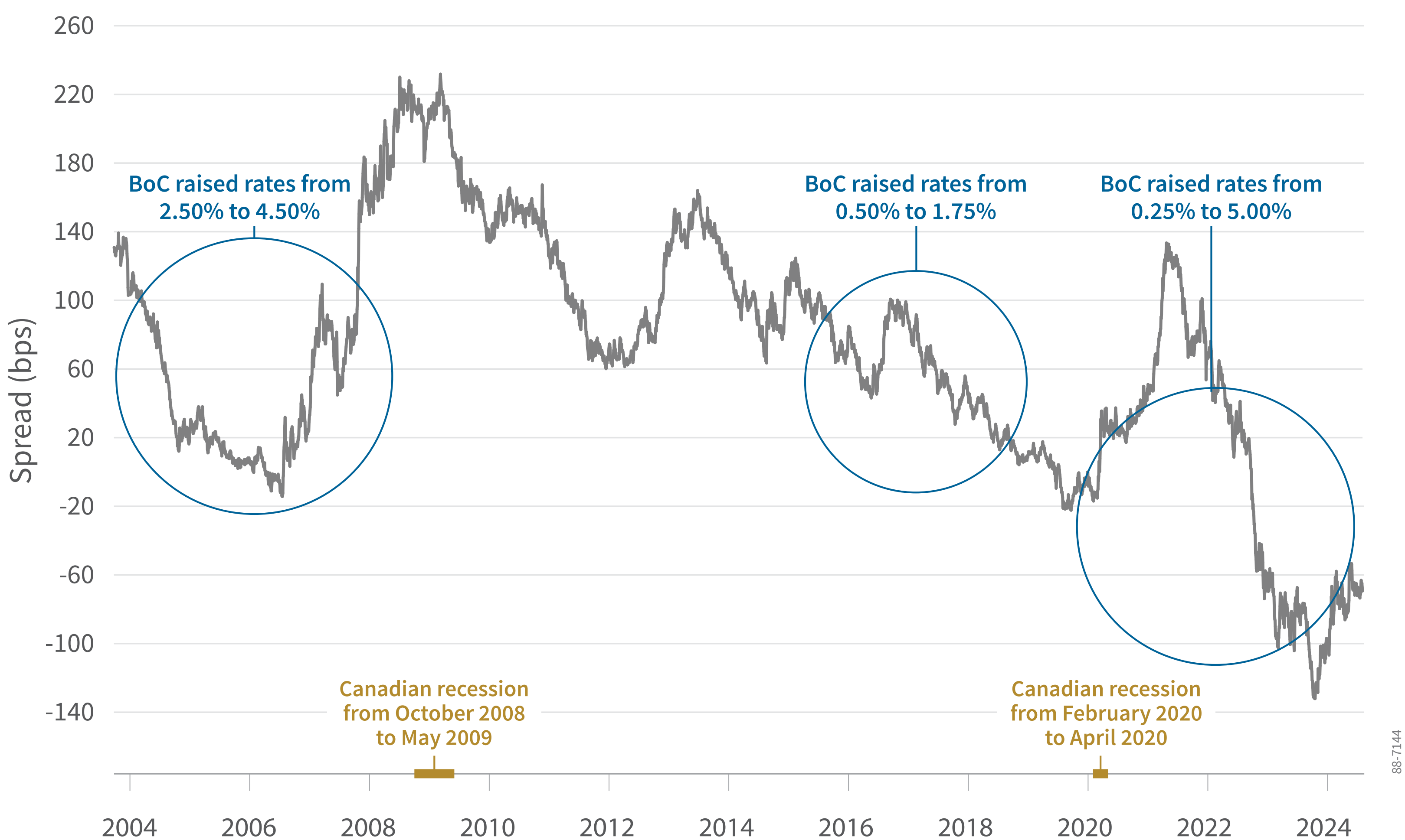
Bonds with shorter maturity dates tend to yield less and bonds with longer maturity dates yield more, giving the yield curve its characteristic upward sloping shape. One reason for this is that the further you are from present day, the less certain you are about a bond's ability to pay back its principal and interest. Therefore, the market demands a premium in the form of a higher yield. In less certain economic times, the yield curve "flattens" as bond buyers anticipate less future growth after inflation, lower longer term inflation expectations and/or uncertain monetary policy.

Today, there is a window of opportunity that may crystallize higher yields on the front end of the curve with still-elevated short-term yields in play. Over time we can expect the yield curve to move toward an upward sloping shape, with investors again receiving the yield premium typical of the long end of the curve.

The inverted yield curve shows signs of reverting

The Canadian yield curve is currently inverted, meaning short-term yields are higher than longer term yields. While this inverted relationship typically signals the onset of recession, there have been signs that the yield curve is reversing course, particularly with expectations growing that the Bank of Canada has finished raising interest rates and may soon be lowering interest rates.

Canadian yield curve - 2/10 Spreads



Anatomy of the yield curve

Where is the opportunity now?

> As this rate hiking cycle ends and longer-term interest rates peak, what does it mean for bonds in the near term? Let's look at current day bond market dynamics to understand where there is the greatest opportunity.

Front-end of curve: The rally will be led by the front end of the curve.

Strategy to participate: Use high-quality, front-end assets as a ballast for portfolios.

Middle of curve: The rally extends to the middle of the curve.

Strategy to participate: Current "sweet spot" – take on intermediate duration and credit risk to potentially participate in upside in terms of price, liquidity and current yield.

Long end of curve: Long end of curve remains rangebound.

Strategy to participate: As rates at present are not attractive on a relative basis, wait until the yield curve resumes a more normal shape to benefit from the term premium.

The significance of duration

Duration exposure is an important lever portfolio managers can use to help mitigate the effects of rising or benefit from falling interest rates. The duration of a bond or a bond portfolio measures its price sensitivity to interest rates. The longer the duration, the greater the potential price gain/loss if interest rates decline/rise.

Lengthening duration (by adjusting a portfolio's holdings) is a strategy typically used by bond managers when yields are expected to decline. As interest rates fall, the prices of bonds rise, so portfolios can benefit from higher bond prices in addition to their coupons. At present, with rates expected to fall, to capture the related price increases, owning bonds with a longer duration relative to cash or benchmark is beneficial.

How sensitive is a bond portfolio to interest rates? Duration in action

Examples of bonds and interest rates	Fund A	Fund B	Fund C
Duration	4 years	6 years	8 years
Change in yield	-1%	-1%	-1%
Approximate percentage change in price	4%	6%	8%

88-7143

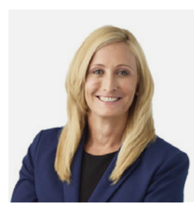
A strategy that is employed by bond managers is to spread their exposure to interest rate risk by laddering the maturities and duration of the bonds across the term maturity structure. This will also help to spread the reinvestment risk of the portfolio and potentially help meet liquidity needs, preventing inopportune bond sales that may crystalize losses. It's important to realize bond fund managers don't buy and hold bonds to maturity. They implement strategies like duration management and bond laddering to diversify their exposure to various risks.

Why cash isn't king (and is actually a risk)

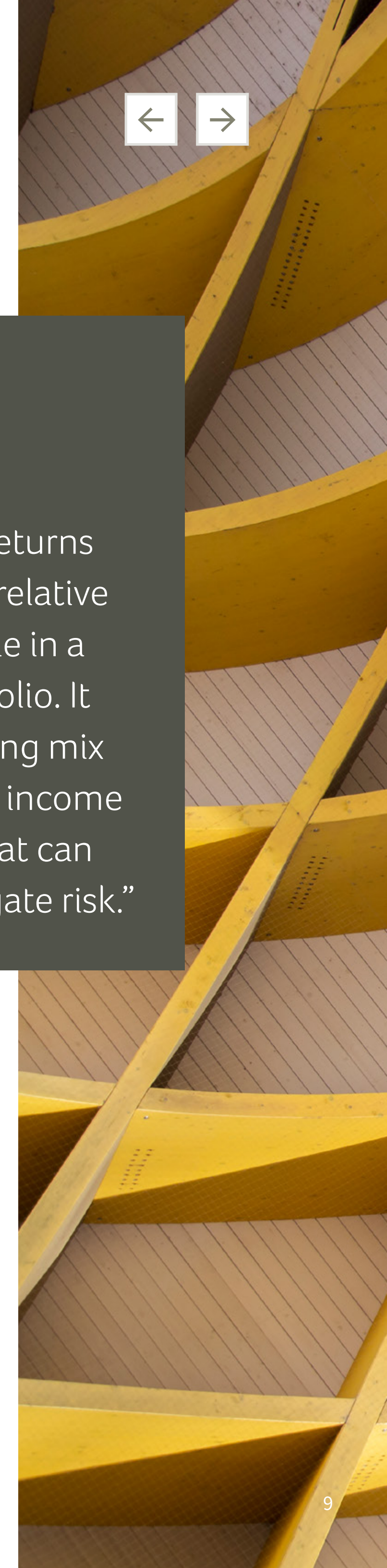
> Cash was the default haven while the central banks were hiking rates, but if market predictions are correct, monetary policy rates could move lower this year and next. This means the "risk-free" cash trade suddenly bears a risk: reinvestment risk. Moving cash into short-duration strategies can help to capture the attractive yield opportunities at the front end of the curve and benefit from potential capital appreciation when yields fall.

There's a significant opportunity cost to being in cash, including the potential loss of return from other asset classes, reinvestment risk and possible loss of capital appreciation due to changes in interest rates. Cash hasn't historically kept up with inflation over the long term. That's why it's important to consider the real rate of return (returns minus inflation) rather than just the observed rate of return.

"Bonds are again a strong contender for asset class returns with an attractive runway relative to cash. They play a key role in a diversified, balanced portfolio. It is important to have a strong mix between stable, core fixed income and specialty strategies that can enhance returns and mitigate risk."



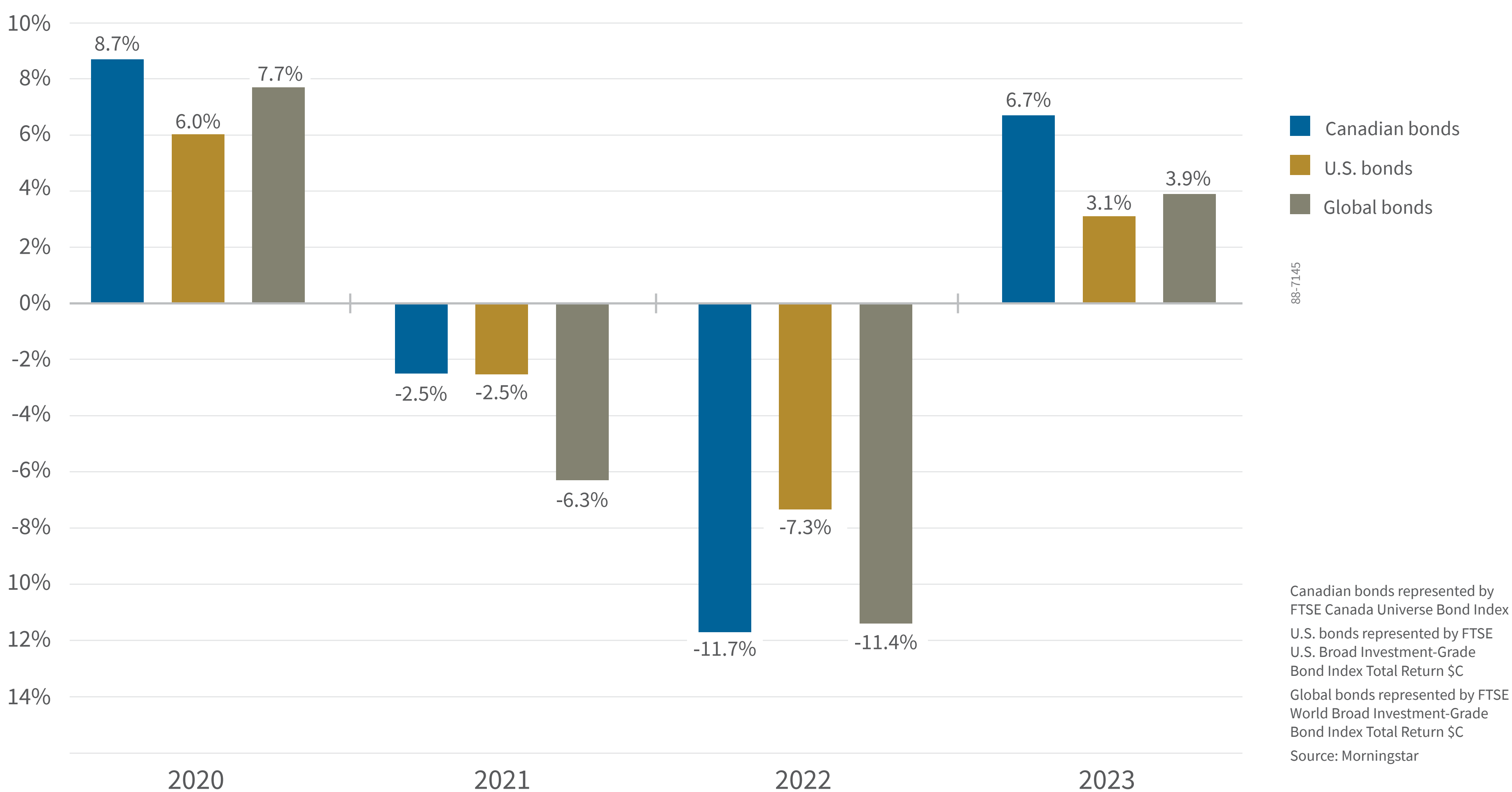
Janet Salter, VP and Portfolio Manager at Portfolio Solutions Group, a division of Canada Life Investment Management Ltd.



The return of bonds

Bond prices have gone through a couple of years of volatility and negative returns. However, bonds are making a comeback in Canada and the U.S., resuming their role as a return generator and diversifier. Bonds are not immune to volatility but have historically provided higher long-term returns compared to cash.

Annual performance of fixed income

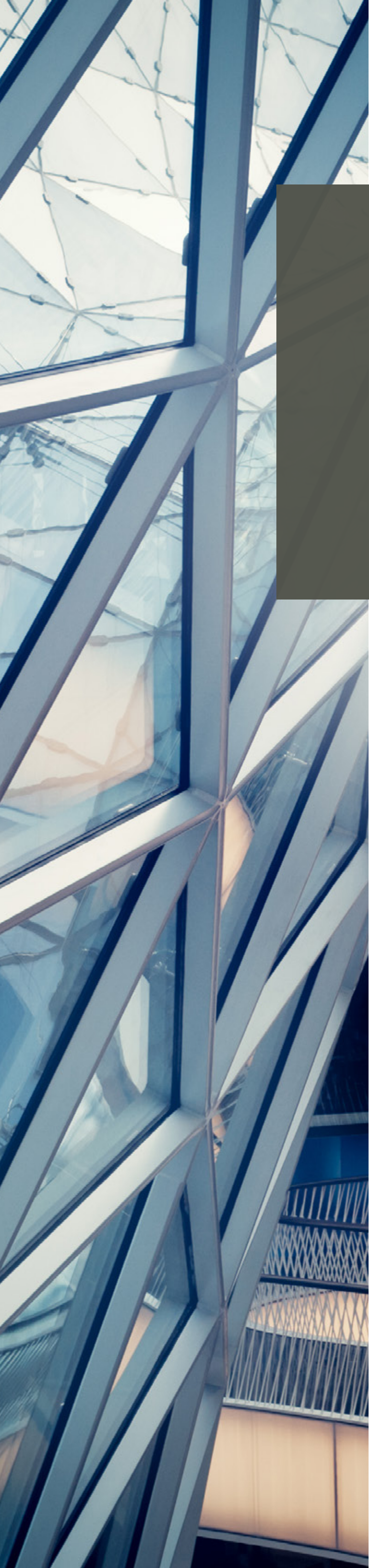


Canadian bonds represented by FTSE Canada Universe Bond Index

U.S. bonds represented by FTSE U.S. Broad Investment-Grade Bond Index Total Return $C

Global bonds represented by FTSE World Broad Investment-Grade Bond Index Total Return $C

Source: Morningstar



The road ahead

The importance of diversification and active management

No macroeconomic or geopolitical environment is static. As market and economic environments evolve, there will be opportunities and risks that arise.

"Bonds should always be part of a balanced portfolio. The role bonds play will vary depending on a portfolio's risk level and time horizon. On the conservative end, they play a stronger downside protection role, whereas on the aggressive side, there's some potential for growth and to help dampen volatility."

– Janet Salter VP and Portfolio Manager at Portfolio Solutions Group, a division of Canada Life Investment Management Ltd.

To address a shifting environment, there are many other levers an active bond fund manager can use. It's not unusual for bond fund managers to use a wide variety of tools, including diversified exposure to specialty bonds as part of an actively managed portfolio. For example, interest rate risk can be mitigated through greater exposure to short term bonds and credit products, such as investment grade corporate bonds, high yield bonds, private credit and mortgages.

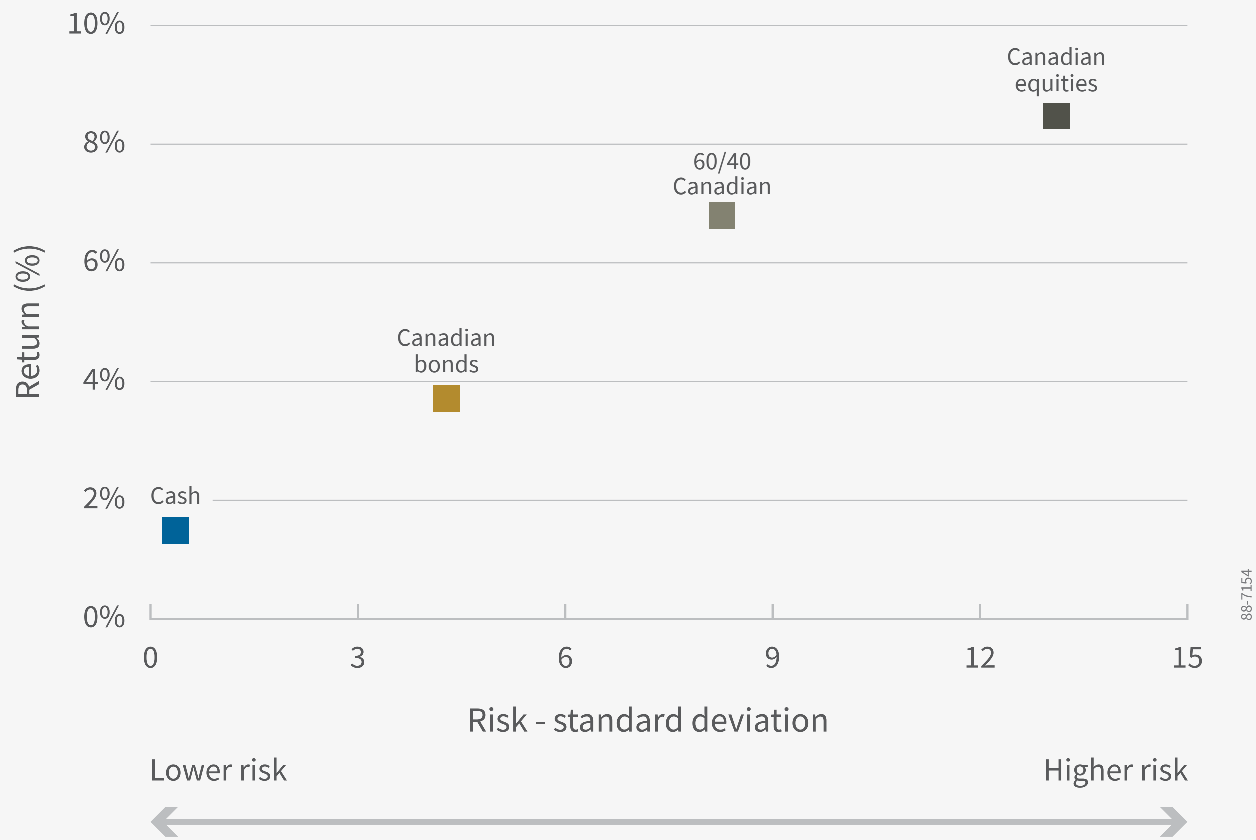
No matter how you look at it, bonds are back.

Bonds help keep a portfolio in balance

Bonds are, and have always been, a critical component of a well-diversified portfolio. While bonds have not historically kept up with the growth in equities, they have delivered lower risk, thus helping a diversified portfolio of stocks and bonds deliver an attractive balance of risk and reward over time.

Risk vs. return over the past 20 years

Despite being higher risk, Canadian equities have outperformed Canadian bonds and cash over the past 20 years.



Canadian equities represented by the S&P/TSX Composite Total Return Index, Canadian bonds represented by the FTSE Canada Universe Bond Total Return Index, Canadian cash represented by the FTSE Canada 30-dayT-Bill Index.

Five takeaways about bonds

1

Attractive yield: Given today's higher interest rates, bond yields are healthier than they've been in over a decade.

Takeaway: After a steep rate hiking cycle, short duration yield opportunities are particularly compelling to potentially enhance income and/or total return profile. As the yield curve moves to upward sloping, these opportunities will shift.

2

Provides diversification: Bonds can help preserve capital and provide downside protection.

Takeaway: With a traditionally low correlation to equities, bonds can be an important building block of a well-balanced portfolio.

3

Long-term outlook for bonds is bright: As the rate hiking cycle comes to an end across many regions, this typically bodes well for bonds.

Takeaway: Bonds are back, but the rate of change in interest rates will depend on several factors, including the rate of economic recovery. While historically less volatile than equity investments, bonds can experience fluctuations in value. Bond investments are best incorporated into an overall long-term approach to investing.

4

Active management is key: A skilled bond fund manager can engage in in-depth analysis to evaluate and select bonds and employ strategies that can mitigate interest rate and reinvestment risk. Depending on the nature of the bond fund, managers can diversify across different bond issuers, credit qualities, sectors and geographies to achieve the right balance of risk and reward.

Takeaway: Active management and the skill of a specialized investment manager is needed to capture opportunity and mitigate risk in the current environment.

5

Supports income and diversification goals: In addition to providing balance and growth in portfolios, select bonds may be particularly effective in generating a steady stream of income.

Takeaway: In general, in portfolio construction, the higher the risk profile and longer the time horizon, the more interest rate risk and credit risk is present. In general, bonds can be suitable for diversification and provide the potential to capture a healthy return over time through both yield and price appreciation.

Unlock the potential of fixed income in today's market

Visit canadalifeinvest.ca

Follow us on LinkedIn

To learn more about Canada Life's investment solutions, including our diverse range of fixed income solutions and bond funds, visit our Investment spotlight or contact your Canada Life wealth wholesaler today.

This material is intended for advisors and investment professionals. This commentary is presented only as a general source of information and is not intended as a solicitation to buy or sell specific investments, nor is it intended to provide tax or legal advice.

The views expressed in this commentary are those of this investment manager as at the date of publication and are subject to change without notice. The content of this commentary (including facts, views, opinions, recommendations, descriptions of or references to, products or securities) is not to be used or construed as investment advice, as an offer to sell or the solicitation of an offer to buy, or an endorsement, recommendation or sponsorship of any entity or security cited. Although we endeavour to ensure its accuracy and completeness, we assume no responsibility for any reliance upon it.

Canada Life funds are available through a segregated fund policy issued by The Canada Life Assurance Company or as a mutual fund managed by Canada Life Investment Management Ltd. offered exclusively through Quadrus Investment Services Ltd. Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently, and past performance may not be repeated. A description of the key features of the segregated fund policy is contained in the information folder. **Any amount allocated to a segregated fund is invested at the risk of the policyowner and may increase or decrease in value.**

FTSE Disclaimer | S&P Disclaimer