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Interest rates are headed higher, so why invest in bonds?

By: Multi-Asset Management

Interest rates in Canada and the U.S. are expected to head higher over the next two to three years. This statement can be made with some confidence, especially given that central banks themselves have signalled more interest rate hikes. As a result, it is often inferred with certainty by some investors that bonds must therefore be headed lower given that bond prices decline as yields rise. However, they may be forgetting that the expected path of interest rates set by central banks is already priced into the bond market. And, for the price of a bond to decline, its yield, which already captures the expected interest rate path and inflation expectations, would need to rise from current levels. In other words, there would have to be expectations for further rate hikes in addition to the currently expected rate increases. This is far from a certainty.

After nearly four decades of declining bond yields, there is a credible case to be made that government bonds, particularly U.S. Treasuries, are due for a change of course and may even enter a prolonged bear market. The U.S. government's spending and borrowing binge is a structural issue that may indeed take decades to be resolved, with the possible fate being a credit downgrade and an increase in the rate it must pay to borrow. The recent uptick in inflation is a normal occurrence at the current late stage of the business cycle. It should easily be tamed with modest rate adjustments, but a loss of confidence in U.S. assets could hurt the U.S. dollar and lead to higher inflation (given rising import prices), which would need to be met with more aggressive tightening by the U.S. Federal Reserve. This would not be good for bonds.

Yet, a bullish case for bonds can be fashioned just as easily. The potential for a trade war involving the U.S. and other G20 nations and the recent ongoing testing of the European Union's structural resilience in Italy are some of the known unknowns that can trigger significant "flight-to-safety" buying of government bonds. Perhaps more importantly, bond investors for many years have been able to count on U.S. policymakers to ease monetary conditions to facilitate the decades-long spending binge at the individual and government level. It is not difficult to imagine yields continuing to grind lower for many more years, if not decades, before lenders begin to lose faith in the infallibility of the U.S. government and demand higher yields.

A third possible scenario, which is heard about much less often in the media, is that bond yields are neither in a downtrend nor an uptrend but stuck in a sideways trading range, alternating between strong and weaker phases. Perhaps this view is less popular because it does not generate as much buzz or excitement as do the other bolder prognostications. However, it is certainly worthwhile to consider given that trends with any significance have historically tended to consolidate for a period of time before changing directions or resuming along the original trend.

A quantitative analysis is helpful when considering whether or not bonds offer potentially attractive risk reward characteristics.

Take, for example, a 10-year U.S Treasury bond that yields 3% and has a duration of approximately nine years. If the yield rises by 100 basis points over one year, the bondholder would earn a negative total return of approximately 6%. This is derived by subtracting the price adjustment of 9% from the yield of 3%. If the yield were to decline instead by 100 basis points over one year, the bondholder would earn about 12%. If the yield is unchanged, the bondholder would earn the yield of 3%. Of course, if one were to hold the bond to maturity, the annualized return is guaranteed (by the U.S. government) to be 3%. Assuming one cannot foresee the future path of yields (not to be confused with interest rates) and thus has a neutral view, this investment offers a favourable risk/reward profile. For those that can peer into the future more clearly, they may come to a different conclusion.

Government bonds are among the least exciting asset classes available but they embody what investing is all about – which is to earn a positive return while safeguarding one's capital. Given their strong tendency to outperform when equities and other cyclically oriented assets are challenged, and their guaranteed positive carry if held to maturity, they have an important role to play in investment portfolios.

Combined top 15 equity holdings as of May 31, 2018 of a representative balanced Private Client Managed Portfolio with alpha-style equity exposure*

1. SNC-Lavalin	6. AltaGas	11. E-L Financial
2. Atco	7. ICICI Bank	12. Mullen Group
3. Suncor Energy	8. Canadian Natural Resources	13. Sinopharm Group
4. Loblaw Companies	9. HeidelbergCement	14. Kunlun Energy
5. CIBC	10. Power Financial	15. Canadian National Railway

Combined top 15 equity holdings as of May 31, 2018 of a representative balanced Private Client Managed Portfolio with value-style equity exposure*

1. Toronto-Dominion Bank	6. Alimentation Couche-Tard	11. Microsoft
2. Royal Bank of Canada	7. Canadian Pacific Railway	12. CCL Industries
3. Magna International	8. Gilead Sciences	13. CI Financial
4. Bank of Nova Scotia	9. Suncor Energy	14. KLA-Tencor
5. Brookfield	10. TMX Group	15. Astellas Pharma

Combined top 15 equity holdings as of May 31, 2018 of a representative balanced Private Client Managed Portfolio with growth-style equity exposure*

1. Canadian Pacific Railway	6. Keyera	11. Intact Financial
2. Tourmaline Oil	7. Walgreens Boots Alliance	12. Restaurant Brands International
3. CSX	8. Nutrien	13. Thomson Reuters
4. Franco-Nevada	9. Praxair	14. Anthem
5. Athene Holding	10. Gilead Sciences	15. George Weston

*Approximately 33% fixed-income, 10% enhanced income, 49% equities, and 7% global real estate.

To see the top 15 holdings of the individual pools or the equity alpha mandates, please contact your Stonegate advisor.