Rate Cuts Have Arrived: Why Now is the Time for Fixed Income

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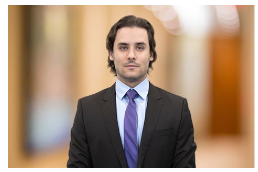

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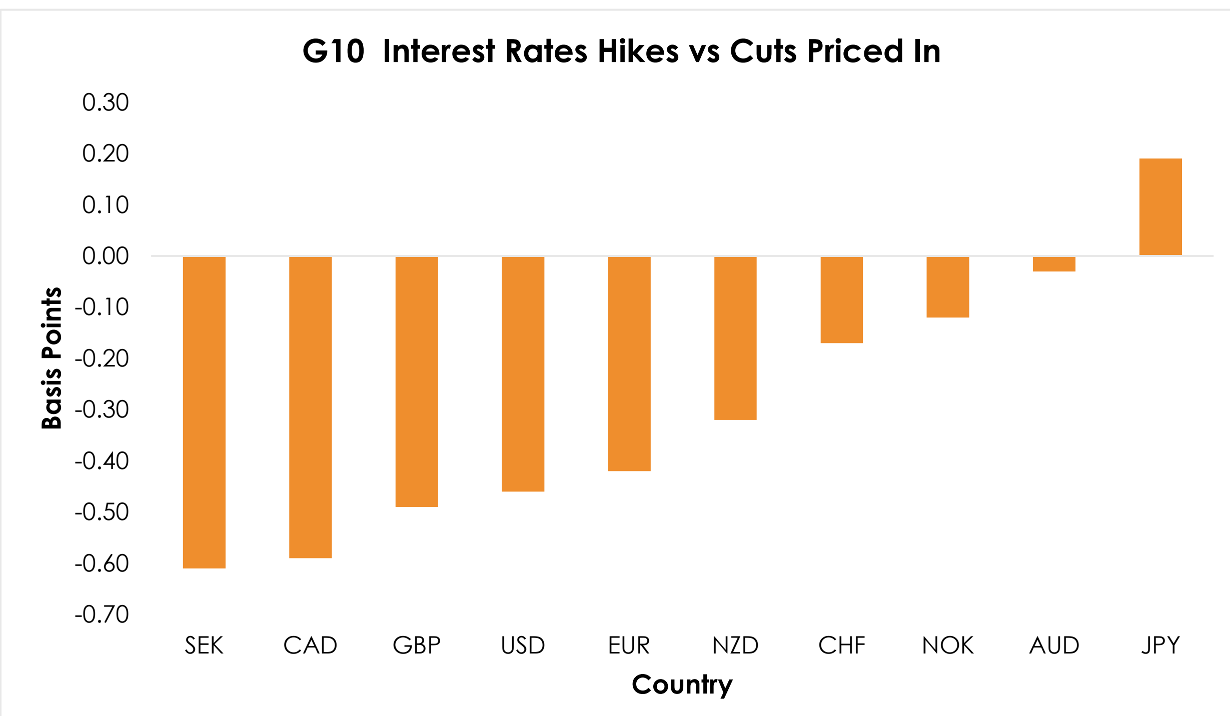
Fixed income investors celebrate as the Bank of Canada begins cutting cycle

After a long period of uncertainty, with conflicting predictions, pessimistic forecasts, and sudden changes in central bank communication, fixed income investors finally received what they had been hoping for from the Bank of Canada (BoC) in June: a rate cut. The cut was not entirely unexpected, with interest rate futures pricing in an over 80% probability in the days leading up to the BoC's decision, and economic and inflation data pointing towards a cut since the beginning of the year. The Bank's preferred inflation measures (CPI Trim, CPI Median) had dropped below 3% in recent months, even with the significant impact of housing and mortgage costs, indicating a more profound slowdown in inflationary pressures.



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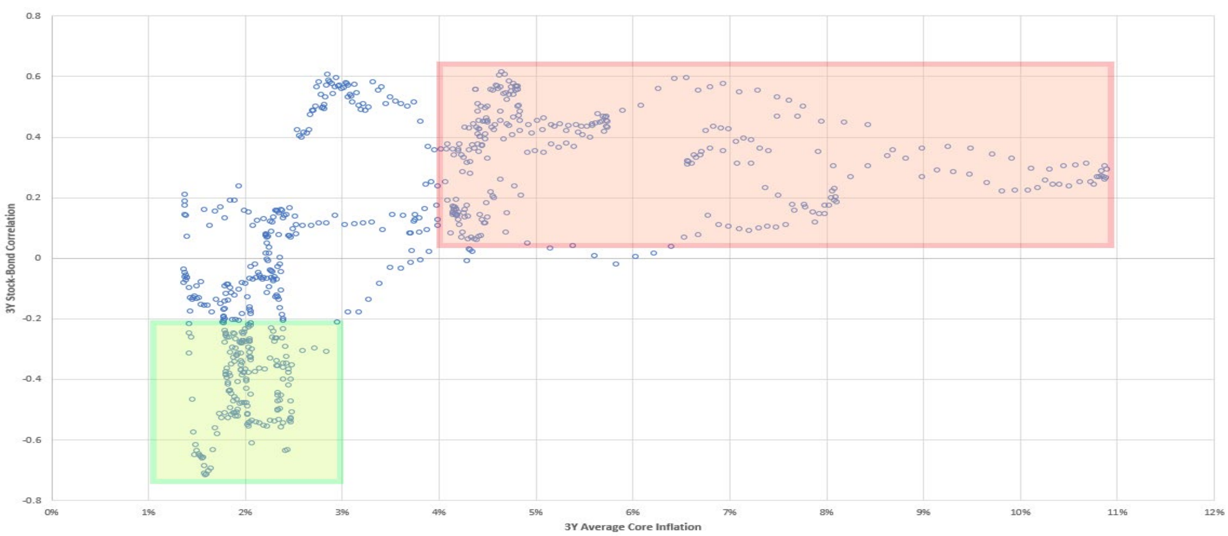
As of June, several additional cuts are expected in most advanced economies, representing a significant shift in the market's views on global interest rates. Canada stands out, along with Sweden, with slightly more than two additional cuts expected by the end of the year and four cuts over the next 12 months, providing a potential tailwind for Canadian bonds. The AGF Fixed Income Team believes that further deceleration in economic activity may become more apparent in the second half of the year, as the Canadian labour market continues to exhibit signs of weakness, and indirect growth drivers coming from the U.S. will begin to abate.

The growing potential for further rate cuts in 2024 and beyond provides a tailwind for fixed income funds, especially those positioned to benefit from a rally in rate-sensitive categories (government bonds, provincial bonds, etc.). Overall, we see several reasons to be positive on fixed income as an asset class.

1. Fixed income looks primed to regain its equity-hedging properties

3 Year Stock / Bond Correlations



Source: AGF Investments and Bloomberg as of January 2024. Correlation analysis was performed using the U.S. 10-Year Treasury Index to represent bonds, and S&P 500 Index to represent equities, dating back to January 31, 1962.

Over the last several years, investors who ventured into the relative safety of bonds as a way of protecting their portfolio from equity volatility likely saw disappointing results, as both asset classes broadly moved in the same direction during periods of market turmoil. While somewhat puzzling at first look, an analysis of historical inflation regimes and stock/bond returns provides some insight into this.

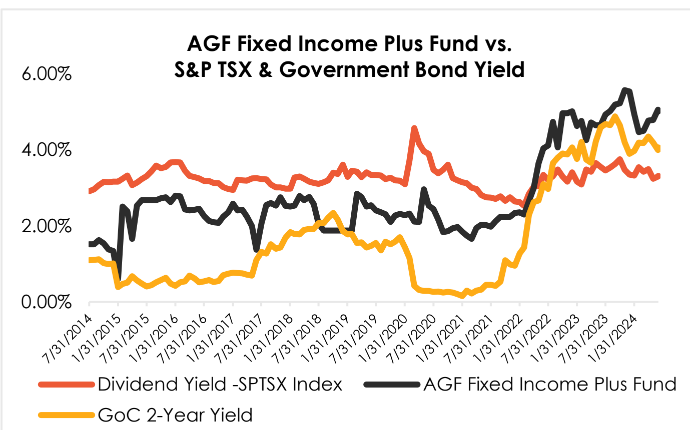
The shaded red area represents historical regimes which experienced above-average inflation, defined as 4%+ on the x-axis, where stock/bond correlations were positive, indicating limited hedging benefits from fixed income. This is the exact environment that investors found themselves in over the last two years, suggesting that, while frustrating, bonds behaved similarly to other historical periods of high inflation.

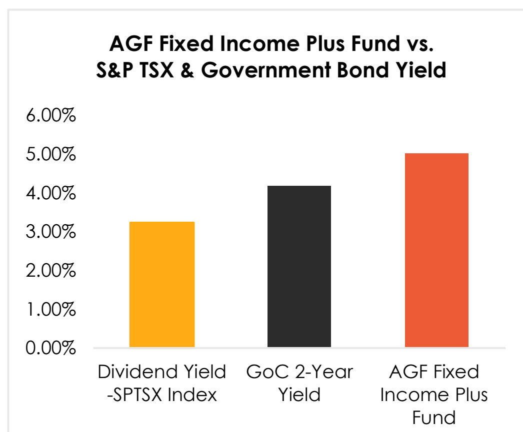
With recent global inflation data coming out of the U.S., Canada, and Europe, evidence is mounting that we are entering the inverse scenario represented by the green shaded area, where stock/bond correlations once again become negative for inflation rates under 3%. In this regime, fixed income has historically regained its equity hedging characteristic, once again providing an effective counterbalance to equity volatility.

2. The highest yields in the last decade breathe new life into the 60/40 portfolio

Beyond the equity hedging narrative associated with bonds, an even more crucial aspect of fixed income has been severely limited in the recent era of near-zero interest rates: the yield profile.

With bond yields having increased significantly in the last two years and now sitting at 20-year highs, investors can once again collect a meaningful coupon on their fixed income holdings, even surpassing the yield provided by the dividend heavy S&P TSX Capped Composite Index, which stood at ~3% as of June 1st. By comparison, the Government of Canada 2-year bond yields around 4% while the AGF Fixed Income Plus Fund yields ~5%.





Source: AGF Investments & Bloomberg as of May 31, 2024. **Past Performance is not indicative of future results.** One cannot invest directly in an index.

In the context of a balanced 60/40 portfolio, this allows fixed income to potentially contribute much more meaningfully to the total return than in the past decade, taking some pressure away from equities, and allowing bonds to do more of the heavy lifting relative to recent memory. To illustrate the concept, consider the two scenarios of a 60/40 portfolio allocation in which bonds yield 2% and 5%, respectively, and the equivalent equity return required for a 7% total return in the portfolio:

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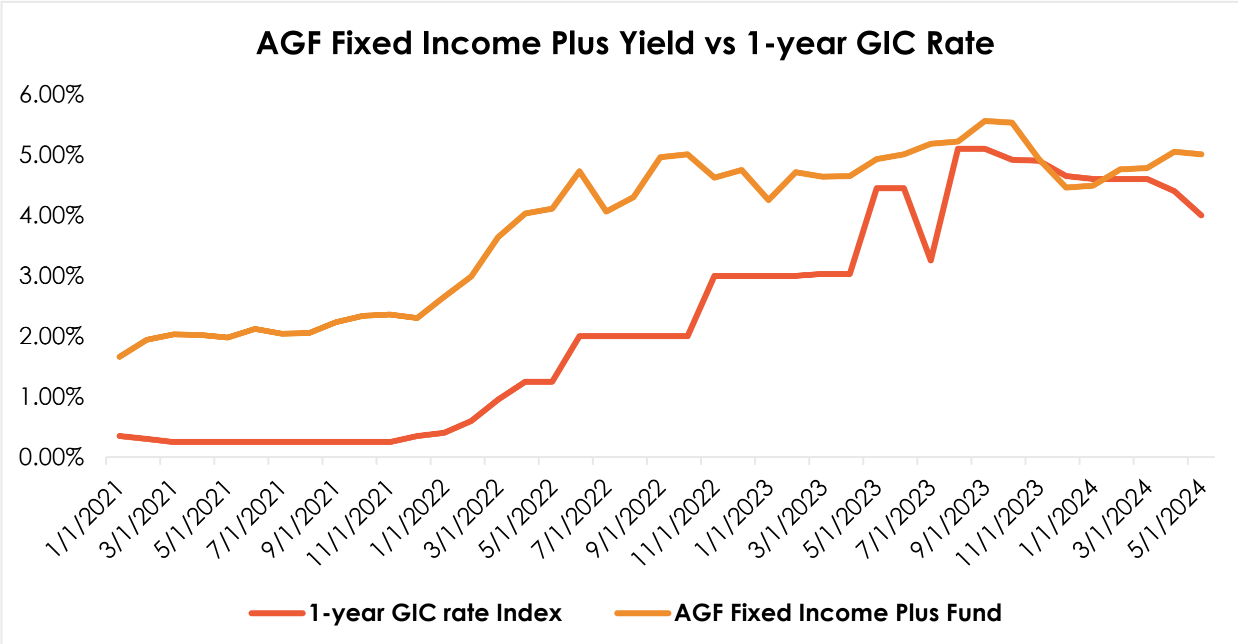
60/40 Portfolio Returns Scenario				
Bond Weight	**Bond Yield**	**Equity weight**	**Equity Return Required**	**Total Return**
40%	2%	60%	10.3%	7%
40%	5.0%	60%	8.3%	

Source: AGF Investments & Bloomberg as of May 31, 2024. Performance returns presented are hypothetical and for illustrative purposes only. It does not represent actual performance, nor does it guarantee future performance. Assumptions were made in the calculation of these returns including duration and yield remaining unchanged, and a total return target of 7%. Any taxes due, trading costs and other fees associated with the portfolios are not included and trading prices and frequency implicit in the hypothetical performance may differ from what may have been realized at the time given prevailing market conditions.

Under the current scenario of a 5% yield, the return required from equities to reach the total return target drops by roughly 20%. This example ignores any potential capital gains that bonds may benefit from as interest rates come down, and strictly assume the yield to be the only source of returns, providing an even more conservative estimate of potential returns.

3. GIC & Cash returns to lag as rates come down

While arguably providing some level of stability to investment portfolios over the past year, GIC returns are entirely dependent on the underlying level of interest rates. This results in potential opportunity cost in a rate-cutting cycle, as investors do not benefit from the potential capital gains associated with traditional bonds when yields begin to fall. Even those willing to forego the potential capital gains for the stable yield may have cause for concern, with 1 Year GIC rates having fallen from 5% to 4% over the past year, representing a 20% drop in the yield provided by GICs. The issue is even more pronounced for products that provide a yield based on the overnight policy rate, given that yields on these funds adjust downward in tandem with rate cuts. In contrast to GIC rates, the AGF Fixed Income Plus has maintained a yield in the 4.5%-5% range over the past year, aided by the out-of-benchmark allocation to convertible and high-yield bonds.



Source: AGF Investments & Bloomberg as of May 31, 2024. Past Performance is not indicative of future results. One cannot invest directly in an index.

Along with several other issues including the lack of liquidity, and the credit risk associated with the GIC issuer, which is often completely overlooked, the appeal of GICs is limited to their yield potential which will be continuously eroded by each rate cut decision in the future.

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