Fixed Income Investing- Why Now May Be the Time To Add

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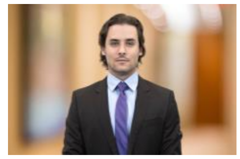

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Key Takeaways:

- Economic sentiment in Canada and Europe is weakening, signaling a potential slowdown. While a recession is not the base case for now, allocating to Bonds sooner rather than later is a prudent move.
- Historically, years with negative bond performance have been followed by 3 years of positive cumulative performance.
- Bonds may offer numerous advantages at this stage of the cycle over GICs and money market funds, including the potential for capital appreciation, higher liquidity, and preferential tax treatment.

No recession in sight, but storm clouds are gathering

The last 18 months have conditioned Fixed-income investors to think twice before allocating to their bond portfolios, as a resilient global economy has kept pressure on central banks to continue hiking interest rates. After several head fakes at the beginning of the year (e.g., a temporary pause in Canada and Australia, the March banking turmoil), yields have continued their trek higher, and seemingly thumbing their nose at the brave few who increased their bond allocations earlier in the year.

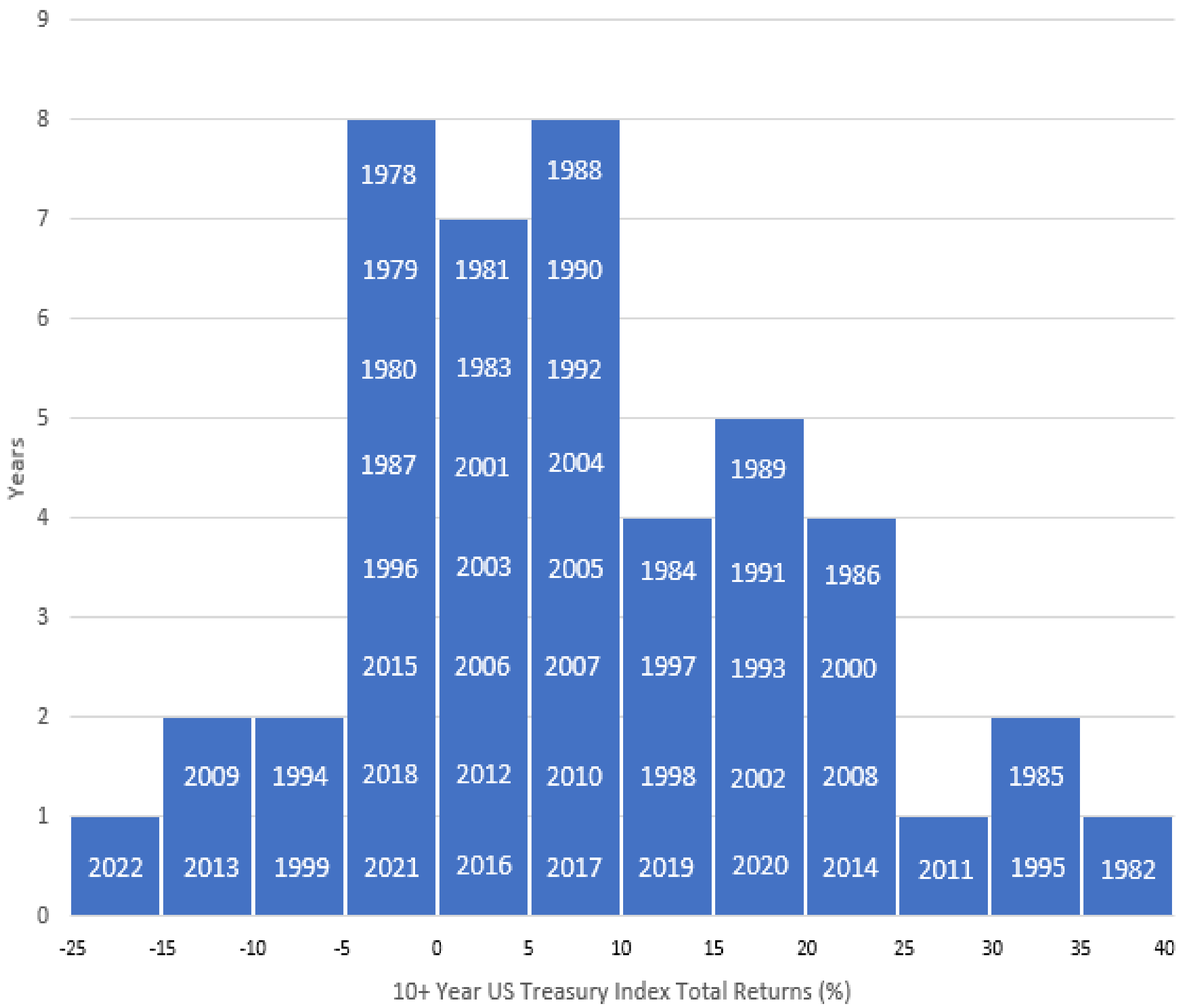
Investors have looked for refuge in Cash and Cash proxies, whether in the form of GICs or money market funds, as sitting on the sidelines seemed like the better option compared to bonds. After the toughest year for fixed income in decades, and a frustrating start to 2023, who can blame them? Still, there is a risk that investors could be succumbing to recency bias and allowing recent outlier events to influence their long-term thinking.

Earnest Hemingway famously said that change comes about in two ways: gradually, and then suddenly. As we enter the 2nd half of 2023, mixed economic data will likely continue for a little while longer, but some cracks are beginning to show in the Canadian and European economies. Global consumer spending is moderating, manufacturing data in Germany has been collapsing, and the much stickier service inflation has started coming down as well worldwide.

Does all of this mean an imminent recession? It is not the Fixed Income team's base case. However, it does show that investors are operating in a different environment than in 2022, and basing their allocation decisions on what **was** rather than what **will likely be**, could prove to be a mistake.

Putting recent performance into historical context

Following two consecutive years of negative returns in Fixed Income, it's easy to understand why some may be getting discouraged. But it's important to keep things in perspective and remember the adage… when in doubt, zoom out!



Source: Bloomberg as of August 31, 2023 **Past performance is not indicative of future results.** One cannot invest directly in an index.

Looking at U.S. 10-year Treasury returns since the 1970s, a shocking, but somewhat comforting revelation becomes apparent: 2022 seems to be as bad as it gets, and an outlier in the true sense of the word. To use a COVID-era term, 2022 was truly unprecedented from a historical context, during a time when central banks' main concern was the sky-high inflation that needed to be brought down at all costs. Although the battle is not over yet, significant progress has been made in curbing inflation and inflation expectations, potentially making it unlikely that a repeat of 2022 is in the books for the years to come.

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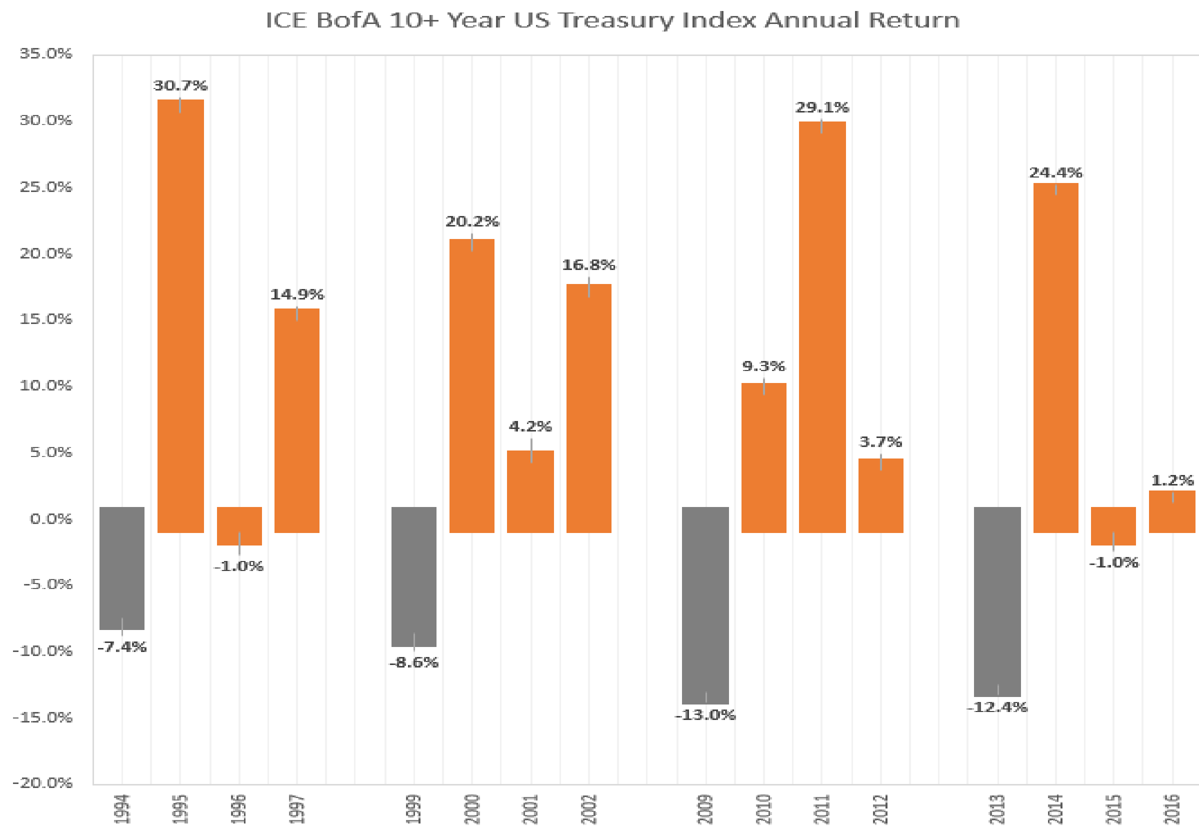
Furthermore, analyzing past periods of significant negative bond market returns and the 3 years following them reveals another consistent pattern dating back to the 1990s. Following a year of significantly negative performance in Treasuries (more than -5%), the following 3 years have exhibited positive cumulative returns. Bond returns are primarily a function of the economic outlook and the direction of interest rates in any given year.



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Bonds vs GICs – Why now is the time for a change

Beyond the historical patterns discussed above, there are fundamental reasons why GICs may no longer be the best option for investors going into 2024. Despite providing higher cash yields than they have in the last 2 decades, and undoubtedly offering better protection in 2022, GICs lack certain characteristics that make Bonds very attractive at this point in the cycle.

1. **Capital appreciation from potential future rate cuts**

Whereas there is a clear negative relationship between bond yields and bond prices, the same cannot be said for GICs or money market instruments. While this may be favourable in a rate hiking cycle as investors do not suffer capital losses, it has drawbacks when rates move lower since investors may not benefit from the inherent capital appreciation that Bonds experience.

2. **Better liquidity in a fragile economy**

Another advantage offered by traditional bonds that is missing in GICs is liquidity. While the higher guaranteed rates seem attractive at first look, investors must commit capital for a specified period in order to fully realize these returns. Any attempt to withdraw money sooner often results in penalties that all but erode the promised rate of return, in the fortunate case that the issuer approves the redemption. While cashable GIC options exist, they also offer much lower yields than the non-redeemable terms, essentially wiping away any benefit of holding them.

This is not the case with Bonds. While a long-term holding period is recommended for any investment, emergencies happen and sometimes require strategic withdrawals from savings accounts. There are no penalties or minimum holding periods for Bond funds, making them a better alternative to GICs in an economy where consumers are feeling more pressure with each rate hike.

3. **Potentially Preferential Tax Treatment**

Along with fee considerations, taxes are often the 2nd most important hidden cost associated with investments. GIC returns are considered Interest, which outside of a tax-sheltered account is taxed at the investor's marginal tax rate. Adding insult to injury, the interest can be taxed before being received. In the case of a 1-year GIC that matures in the summer of 2024, this means investors will pay tax on the accrued interest for 2023 before seeing a penny of it available for withdrawal.

Bonds may have numerous advantages from a taxation perspective, as distributions can be a combination of interest, capital gains, or return of capital, which blunt the impact of taxes and may even reduce the overall cost bases. Furthermore, High Yield and Investment Grade bonds are trading at a discount to their par value currently, potentially providing an opportunity for investors to generate tax advantaged capital gains, in comparison to the fully taxed interest income earned by GICs.

As interest rates move lower, Bond prices appreciate in value-creating capital gains for investors, which are treated preferentially to Interest income when held outside of a registered account.

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