TD Wealth

The Power of Yields

Market Insights

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Wealth Investment Office

The Power of Yields

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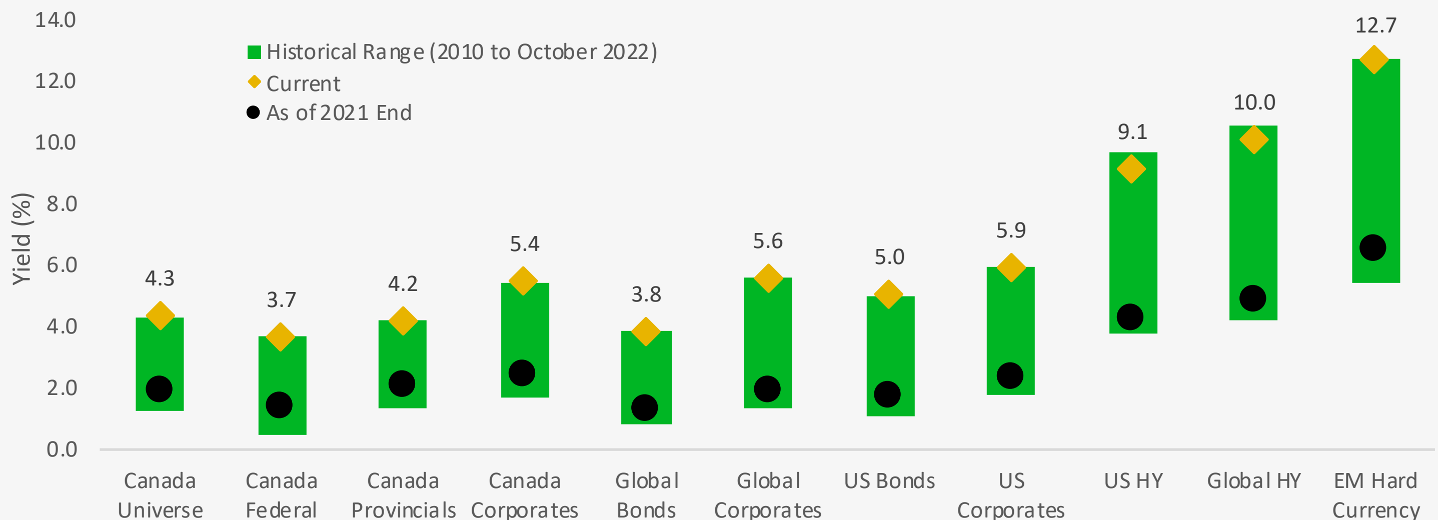
This year has been very challenging for fixed income investors and it is understandable that some may feel uneasy allocating funds towards fixed income amid surging inflation, volatility, and losses caused by rising policy rates, but today's starting yields offer attractive entry points for those able to look beyond near-term volatility. Yields across fixed income sectors are as high as they have been over the past decade and offer real potential for attractive future returns (figure 1).

While it's still important for investors to act with caution and be flexible and ready to change positions when it comes to portfolio decisions, we believe the investment outlook and conviction is very attractive for bonds:

- We are maximum overweight fixed income investments in general and modestly overweight domestic government (U.S. and Canada) bonds. Canadian and U.S. government bonds have become more attractive at current yield levels despite higher volatility as growth concerns look set to eventually win out over inflation in the long run.
- We remain modestly overweight investment grade (IG) credit largely because of the resilience offered by robust balance sheets. Limited new bond issuance, or supply, continues to support valuations. High-quality issuers in the IG credit universe have over the past few years generally taken a conservative approach, built up inventories, raised debt to support future liquidity requirements and refinanced near-term outstanding debt. We continue to focus on fundamentals and valuations have clearly become more attractive with most of the IG universe trading at a discount.
- We maintain our modest underweight view on high yield (HY) credit. The HY credit market is in a unique cycle with changing characteristics that have boosted overall quality and tightened spreads. This should keep spreads from returning to previous levels during recessions, but spreads will widen if the growth outlook keeps deteriorating.

Figure 1: Yields, the most crucial valuation metric for fixed income instruments, reset to 12yr highs



Source: Bloomberg Finance L.P., TD Wealth, as of October 31, 2022

Government bonds

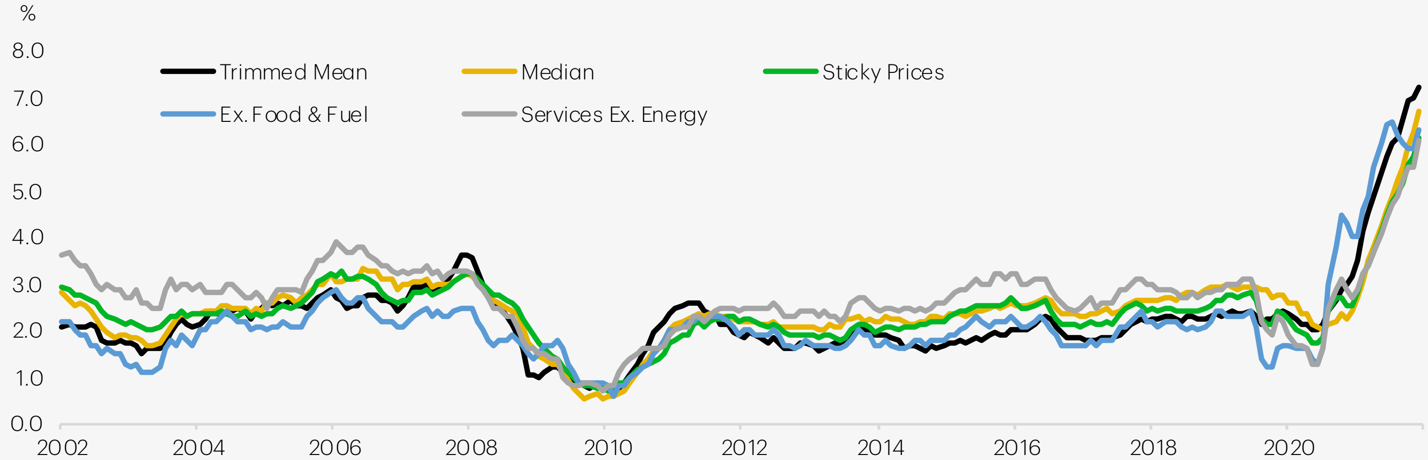
Policymakers shrugged off what looks to be an impending global recession and doubled down on their efforts to beat inflation. Even after the slew of interest rate increases over recent months, many central banks remain far from terminal policy rates.

With terminal policy rates in many countries around neutral or heading into restrictive territory, we expect 10-year government bond yields, some of which are at the highest level since 2010, to decline and remain below policy rates in coming months. We also expect central banks to hold rates at terminal levels for much of 2023, even if economic growth slows, as they gauge the strength or weakness of labour markets. Amid this, Canadian and U.S. nominal government yields are likely to remain range-bound with bursts of volatility. In the near term, inflation inflation and systematic shocks or events we haven't even imagined (like the U.K. gilt market) remain key risks to government yields.

United States

The macro outlook and forecasts have clearly evolved since summer. Inflation looks stickier and wider spread, wage inflation has accelerated, and inflation expectations have shot up (Figure 2). Economic data shows the economy reaccelerated after a weak patch in May and June, and the labour market appears particularly resilient in the face of energy market volatility, tighter financial conditions, and other turbulence.

Figure 2: U.S. inflation measures point to stickiness and more diffusion

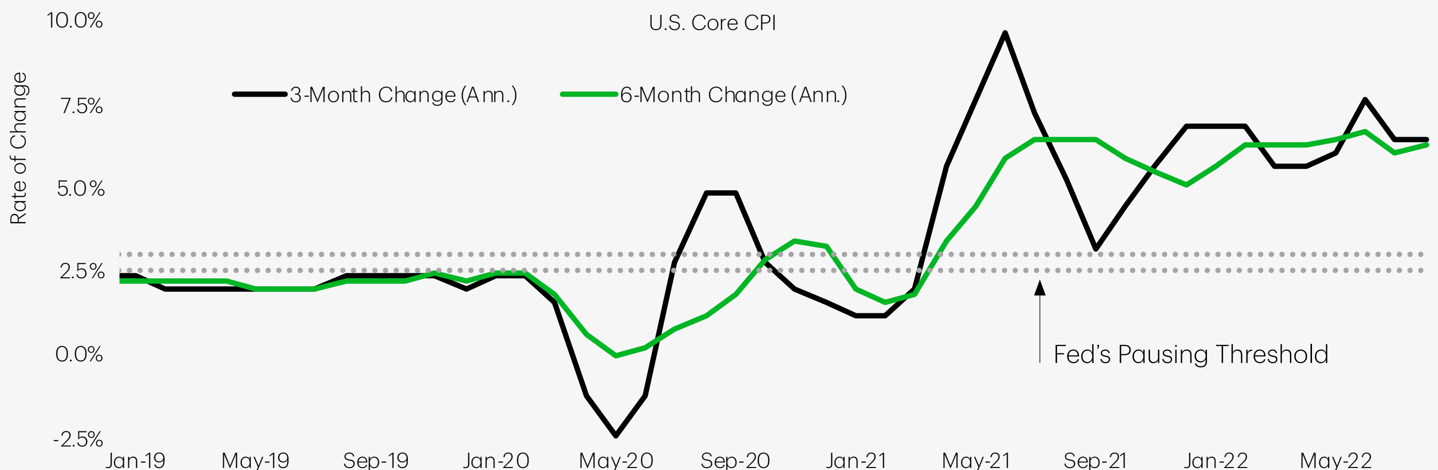


Source: Bloomberg Finance L.P., Federal Reserve, TD Wealth, as of September 30, 2022

As you know, the Fed responded quickly to inflation data, hiked the policy rate several times over this year and increased its outlook for 2022 and 2023 interest rates, taking the projected median terminal policy rate to 4.6%. Even though the Fed didn't project weaker U.S. GDP, it appears increasingly likely that we will have to experience higher unemployment and slower economic growth to curtail inflation. In its May report, the San Francisco Fed estimated the nonaccelerating inflation rate of unemployment (NAIRU) at 6% suggesting U.S. unemployment, running near 50-year lows, and pinned at 3.7% in November, has quite a gap to fill before it helps tame inflation.

The Fed is obviously still concerned about the strength and tenacity of inflation (Figure 3). While Fed officials have acknowledged economic growth is taking a back seat to inflation, no central banker is going to admit they're aiming for recession. Persistently high inflation has capped real interest rates (nominal yields adjusted for inflation) at low levels and broadening inflation suggests we'll need more monetary tightening to push real rates above neutral. And over all of this hangs the cloud of second-round effects: elevated inflation could mean people anticipate even more inflation in the future and push us beyond pandemic-related supply shocks into a more acute and entrenched inflationary trend. The Fed definitely doesn't want this.

Figure 3: The Fed and investors will monitor the rate of change for inflation in coming months



Source: Bloomberg Finance L.P., TD Wealth, as of September 30, 2022

We don't expect the volatility affecting government yields to dissipate any time soon. Depending on data and changes to the environment, the Fed could flip and decide economic growth is more important than inflation. Over the short-term, we anticipate U.S. government bond yields will remain range-bound with upside risk depending on incoming economic data and imported turbulence from other major government bond markets (U.K. gilts).

We believe current levels are attractive enough for long-term investors to pursue if they are willing to weather the short-term volatility. Even if inflation readings remain high and the Fed keeps hiking rates, longer maturity yields will perform favourably as the inflation risk premium declines and growth concerns step to the fore.

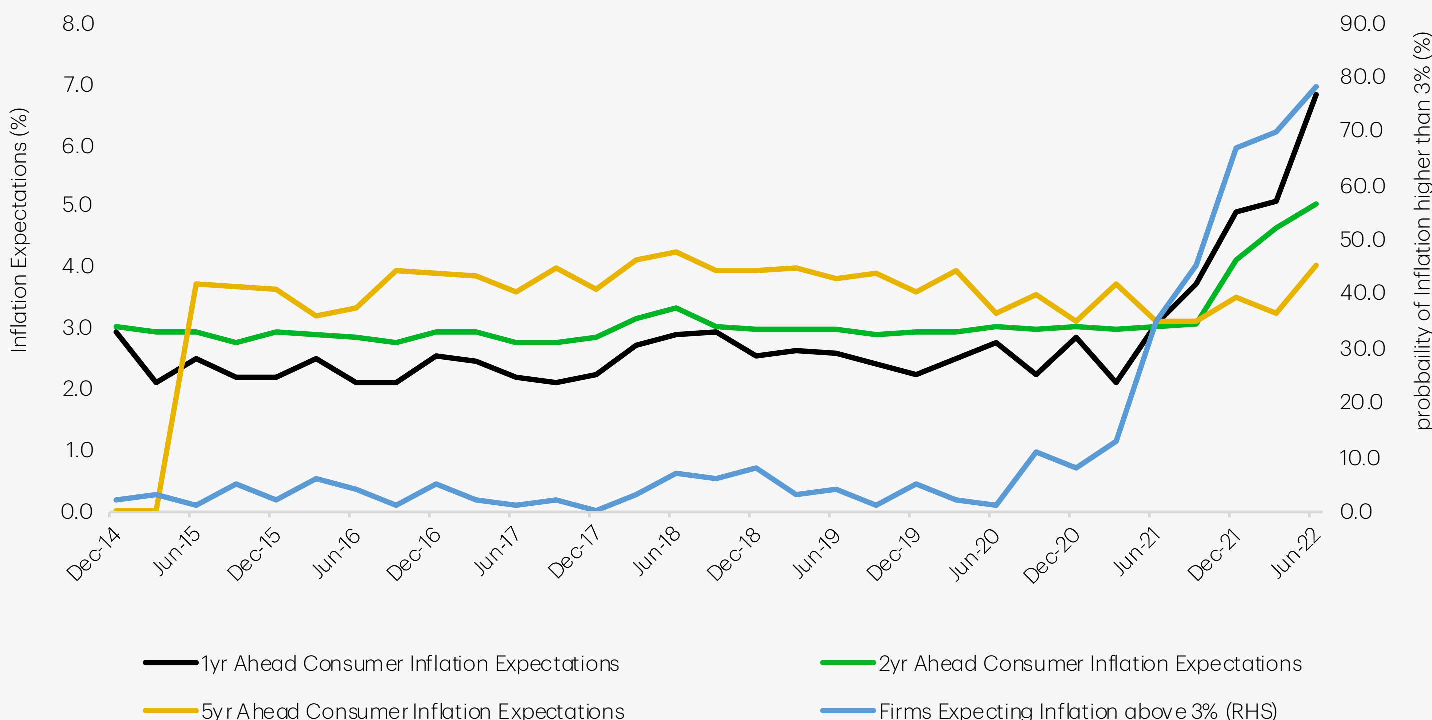
Canada

For the first three quarters of the year it was clear that the BoC (Bank of Canada) needed to jack up policy rates: the economy was nudging further into excess demand, inflation was surprising to the upside and, until July, policy rates were accommodative or below neutral. The BoC's balancing act is about to become trickier as growth slows (GDP growth could be slower than population growth for the next four or five quarters) amid tightening financial conditions, and inflation looks to have peaked or close to it. Slack in the economy and restrictive policy rates will eventually start to slow inflation but could take some time.

Back in December 2021, the BoC introduced a two-tiered mandate (inflation plus economic growth) which allowed it to work towards supporting employment once inflation goals were met. That scenario is long gone. Now the BoC is only paying attention to growth insofar as it feeds into future inflation, indicating a willingness to tolerate slow growth. We should also note that the BoC was quite blasé about the housing market during the exuberance of the last two years so we doubt it will throw more than a passing glance at the sector on the way down.

In a more typical hiking cycle, the BoC would probably be content to pause here, given the growth outlook, and let inflation drift back to target. However, BoC members have voiced some concern that persistently high short-term inflation expectations could become entrenched into longer-term expectations, making their eventual 2% target more difficult to achieve (Figure 4). In this context, the BoC could work to stifle inflation quickly, overshoot and force the terminal policy rate higher than planned.

Figure 4: BoC surveys show short-term and longer-term expectations unanchored



Source: Bloomberg Finance L.P., Statistics Canada, TD Wealth, as of September 30, 2022

Credit: investment grade and sub-investment grade

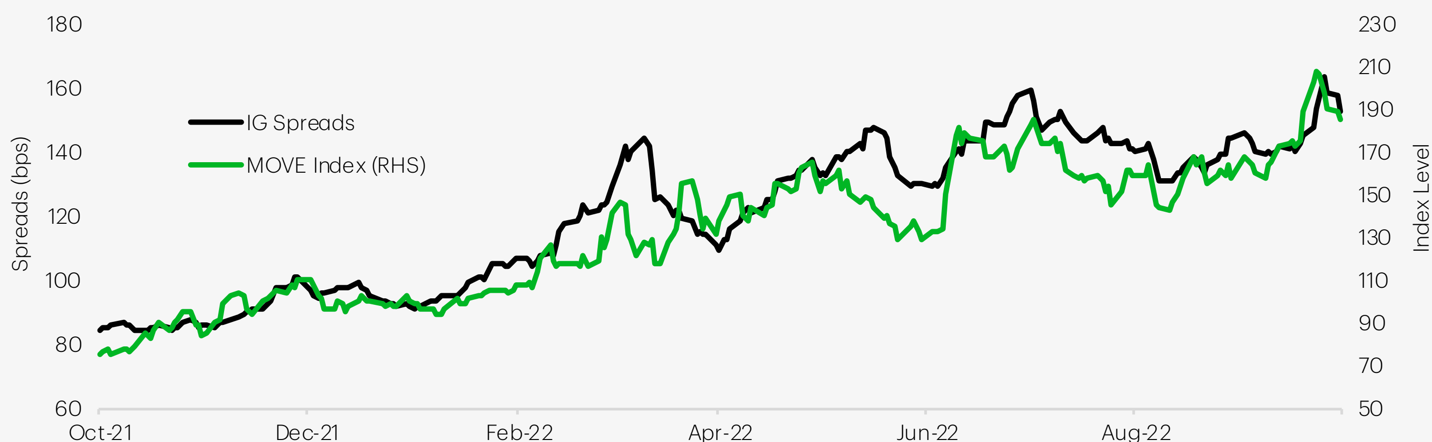
As you can imagine, the abrupt move by central banks to strict monetary tightening has sent credit investors scrambling and filled our inboxes with questions. Investors want to know how much the rising cost of financing will affect corporate balance sheets and whether credit markets are the canary in the gold mine or about to become part of the problem as they did in the 2008 global financial crisis (GFC).

Overall, we are modestly constructive on Investment Grade (IG) credit and maintain our defensive stance on High Yield (HY) credit. While the potential for a near-term payment shock is low for all credit groups, if growth stagnates and funding costs return to pre-GFC levels, we can say adieu to three decades of improving interest coverage ratios. (Higher interest coverage ratios reflect a company's ability to repay debt and indicate robust financial health.)

We believe IG-rated companies, which have a longer maturity profile, more financial flexibility and operational agility are well positioned to adapt to higher funding costs without rating downgrades. HY credit bond issuers are also well positioned given their exceptionally low refinancing needs for the next two years. However, persistently higher yields will eventually weigh on interest coverage ratios, exposing problems that may have been laying dormant during the last 14 years or so of low yields.

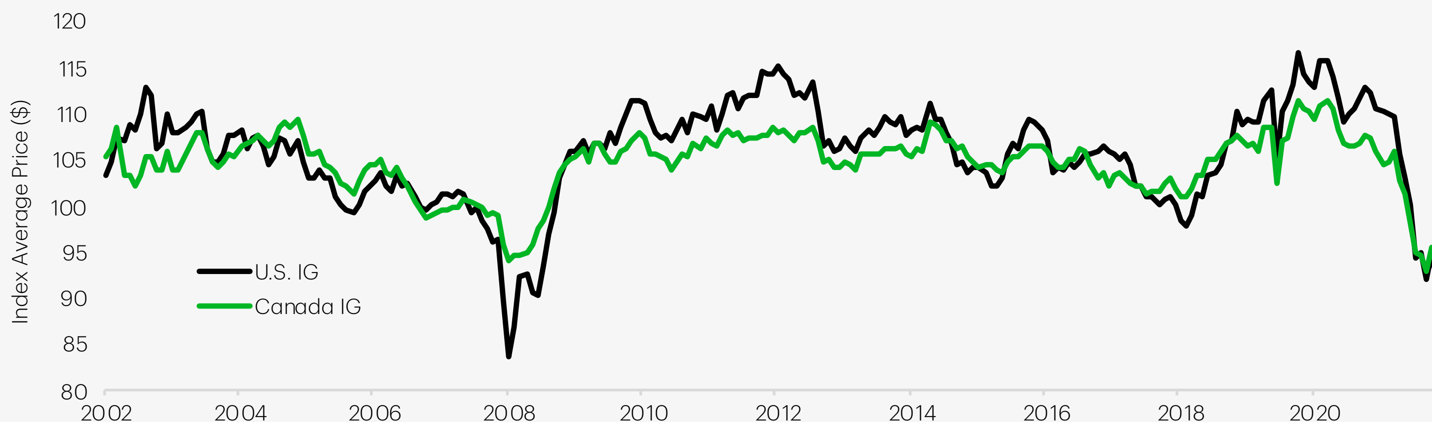
We remain cautious on credit spreads in the near term due to their strong correlation with government bond yield volatility (Figure 5). We continue to focus on fundamentals and relative value: valuations have clearly become more attractive with almost 90% of the IG universe trading at a discount. Dramatic interest rate moves have brought IG credit prices to new lows and close to levels unseen since the darkest days of 2008 (Figure 6); underlying bonds will mature at par value and therefore, at current levels, many bonds look priced for a Black Friday sale.

Figure 5: IG credit spreads widen with government bond yield volatility



Source: Bloomberg Finance L.P., TD Wealth, as of September 30, 2022.

Figure 6: IG credit indices trade at lowest price since 2009

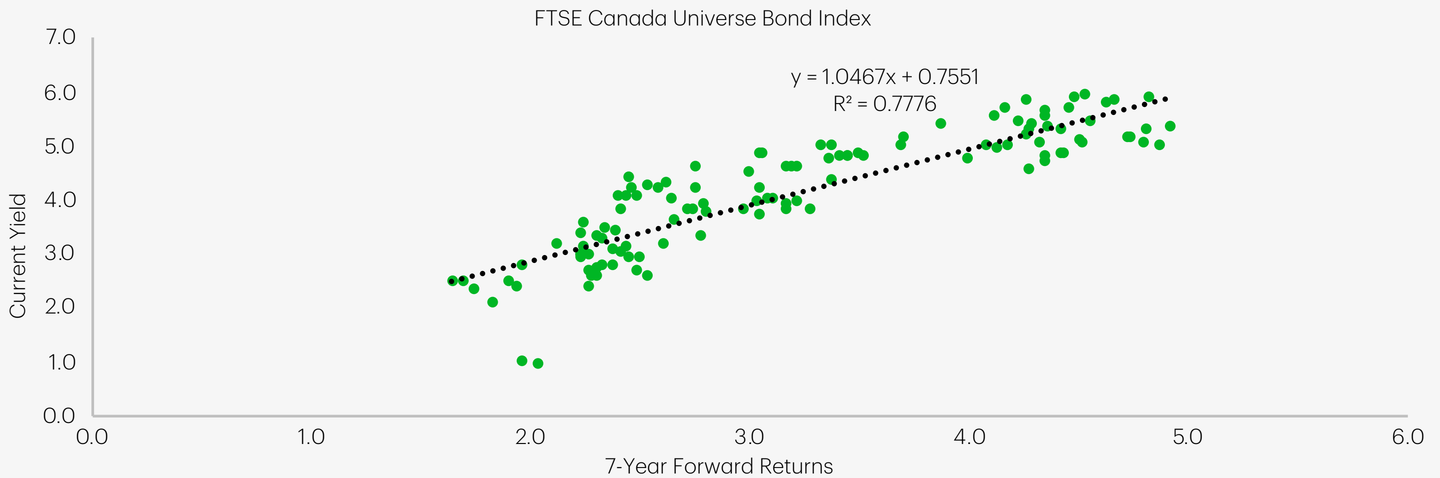


Source: Bloomberg Finance L.P., TD Wealth, as of September 30, 2022.

Higher yields: a blessing in disguise?

Historical data suggests that higher yield levels translate into higher total returns in the future (Figure 7). This means that investors could benefit from holding bonds across fixed income asset classes—including government bonds, IG and HY credit, and even emerging markets bonds—because increased income tends to bolster total returns over time, even if prices remain volatile in the short term. In fact, a greater portion of income needs for investors can now be met with traditional fixed income than would have been the case in recent years. Bonds tend to perform well during recessionary periods meaning the backdrop for fixed-income investments could be even stronger when Fed actions start to clip inflation, which may be in the not too distant future. Remember, higher potential income and improved diversification are two of the bedrock reasons for owning bonds.

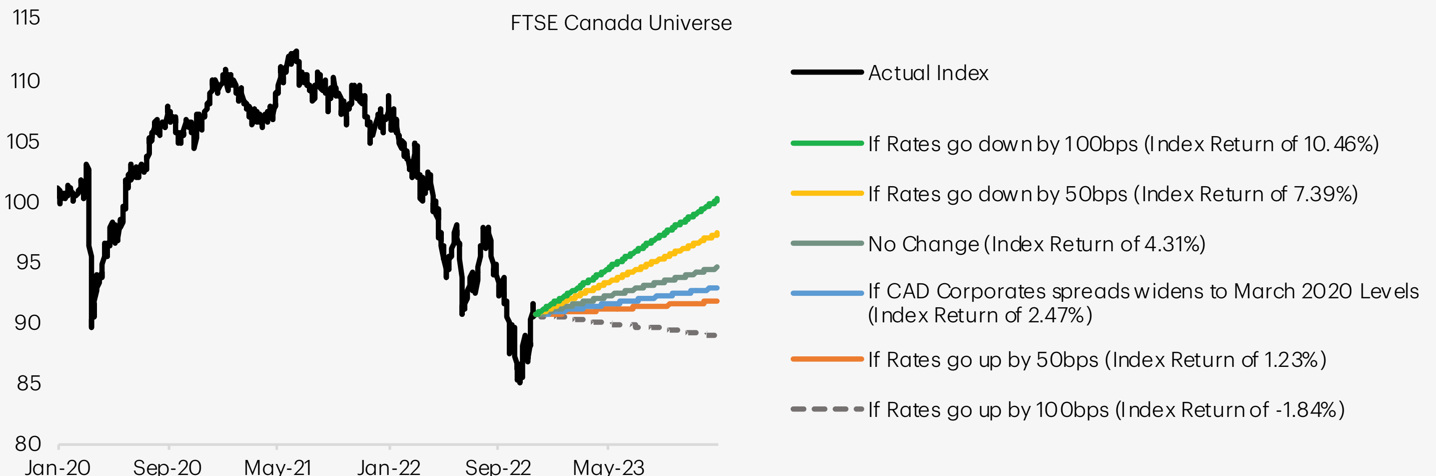
Figure 7: Yield is a good indicator of future returns



Source: Bloomberg Finance L.P., TD Wealth, as of September 30, 2022

With the Canada 10-year yield around 3.1% (as of November 21) and most high-quality bonds offering even more, fixed income could provide positive real yields in a comparably safe and liquid asset. Other relatively defensive areas of fixed income markets are also offering more attractive yields than we've seen in some time. This has helped to increase potential income for investors while offering more downside protection because higher yields can offset losses from a price rout in the near term. For example, the FTSE Canada Universe bond index will post positive returns even if 10-year yields jump another 50 bps over the next 12 months. If yields go up 50 bps, the index will still deliver a return of +1.23% (Figure 8). Higher yields mean that bonds have a larger cushion protecting their total return from any negative surprises in the future. That is the power of yield—capital preservation plus income!

Figure 8: Yield buffer to mitigate adverse scenarios



Source: Bloomberg Finance L.P., TD Wealth, as of November 21, 2022

While uncertainties abound and the world seems unpredictable, try to remember we're not the only investors to find ourselves at the sharp end of a painful market. If you can see through the temporary clouds, recent declines have reset asset valuations and set the stage for better future returns.

We have moved to maximum overweight for the fixed income market overall. Our base case view is that government bond yields will remain largely range-bound with high daily volatility. If more policy rate spikes take us by surprise, shorter maturity bond yields could jump. However, we believe the hawkish stance of central banks is adequately priced into current yields and medium to longer maturity yields should stabilize as focus eventually returns to slowing economic growth. We continue to monitor inflation and economic growth, the two main players affecting short- to medium-term government bond yields: a growth scare will push yields lower while slower-than-expected deceleration or persistent future inflation will support yields. In credit markets, we expect spreads to remain resilient for the coming months, but they could move higher if recessionary fears deepen. We are modestly overweight IG credit and maintain our defensive view of HY credit.

A final note on fixed income

With yields finally reaching attractive levels, the inherent volatility will likely persist as market participants constantly reprice inflation and growth concerns. The ability of bonds to fulfill their traditional roles of acting as a risk diversifier, will be restored once the inflation narrative defers to slowing growth and the hiking cycle pauses. We reiterate the key aspects of fixed income investing:

1. Fixed income portfolios are not meant to capture upside risk.

2. Fixed income is more than just government bonds. The current market environment calls for a flexible approach to building resilient fixed income portfolios, including diversifying sources of return within fixed income and emphasizing relative-value opportunities when generic beta exposures don't look compelling.

3. Maybe the most important aspect is that duration, or interest rate risk, still has a role to play in portfolios. Duration tends to have a negative correlation to other risk assets and the role of the duration and the fixed income asset class, as a whole, has taken a beating in the high inflation environment but we need to remember that higher yields translate into enhanced downside protection if markets sell off. Importantly, this long-term negative correlation with risk assets tends to act as a risk hedge and this is unlikely to change looking beyond the current high inflation environment. With more policy rate hikes on the horizon and low convictions around the direction of government bond yields, we don't suggest investors offload all duration-heavy solutions or core bonds. Rather, we encourage tactical adjustments because we firmly believe there is an appropriate place for duration as a hedge in portfolios.

If investors move towards lower duration and riskier credit solutions in the fixed income sleeve, they must remain vigilant of the inherent drawdown risks as losses in the riskier parts of fixed income can be severe. Importantly, with higher yield on offer within high quality fixed income, the need to dive into riskier fixed income components might be unnecessary. Finally, investors must monitor potential total return losses, and they should not overlook the attractive levels of all-in yield or the income that fixed income investments can deliver from now on.

Consider the drawdown risks acceptable to clients who are investing heavily in fixed income and evaluate probable income versus probable drawdowns instead of probable returns versus probable volatility.

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