TD Wealth

High Time

Monthly Perspectives
May 2024

15 minutes

High Interest Rates (and that's not necessarily a bad thing)

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Early this year, prognosticators and investors were optimistic about rate cuts, with the bond market pricing in a whopping six for the year. These same folks, it should be noted, were highly pessimistic about what would happen to financial markets if these cuts didn't happen. Well, here we are five months into the year and, thanks to stubborn inflation and an American economy that just won't make a soft landing, two things are clear: (1) interest-rate cuts in the United States are not coming any time soon; and (2) financial markets are anything but dire.

Welcome to "high" for longer. Please note I did not write "higher" as has been catch phrase for the past few weeks. "Higher" implies a return to the recent past, the decade or so of ultra-low interest rates following the Great Recession. That era has reshaped a generation of market participants, altering longstanding assumptions about interest rates, economies and markets. We have become accustomed to interest rates going lower and investing accordingly. This low-rate regime has also come and gone, and so it's high time we recognize this and start thinking differently about interest rates and how to invest. This month's Perspectives is an acknowledgement of this fact and our best thinking on what to do about it.

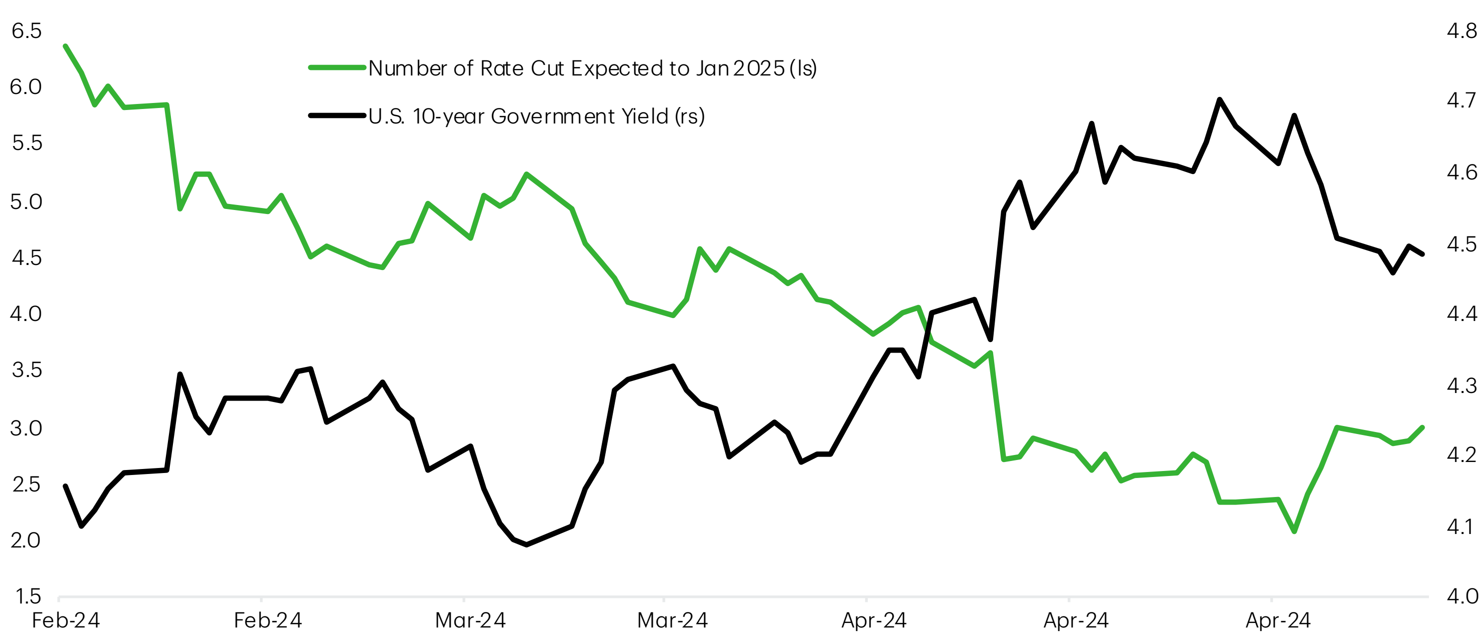
To cut, or not to cut

This year has been an awakening in slow motion as the Fed has continually pushed out the prospect for rate cuts. Correspondingly, market expectations for the number of cuts for the year have been slashed to merely two (Figure 1). TD Economics has been even more assertive than the consensus, with a call for only one rate cut this year due to the recent rise in inflationary pressure, making it difficult for the Fed to maintain confidence that inflation will return to the 2% target in a timely manner. Further, TD Economics expects core PCE to edge back up towards 3% y/y in the coming months (from 2.8% in March).

This speaks to the staying power of inflation in the absence of a "growth sacrifice" in an economy that remains in excess demand territory. All in all, our economics team believes that consumer spending must ease for inflation to return, and be sustained, on a 2% path. There is only limited evidence that this is beginning to happen, and certainly not enough to cause a sudden capitulation in underlying inflation dynamics.

Much of this is due to the fact that, while the Fed has worked to tighten financial conditions, the U.S. government has essentially worked against it, investing in enormous decades-long infrastructure projects. For the Fed, this is akin to running a race while someone unties your shoelaces. It has stoked inflation, which has remained stubbornly high, while labour demand is still rising in the health-care, education and government sectors. All these factors have extinguished any urgency the Fed might have felt earlier in the year to ease monetary policy.

Figure 1: Rate cut expectations plummet



Source: FactSet, Wealth Investment Office (WIO) as of May 9, 2024

So, if we're entering a period of high interest rates, what does that mean? Time to head for the exits? Unfortunately, we've seen plenty of that already as investors move en masse into short-term deposits and money-market funds, but professional money managers need to steer their clients away from this knee-jerk reaction. While it's true that higher rates will act as a brake on the economy overall, and ultimately corporate earnings, the idea that higher rates are bad for investors, and lower rates are good, is just too simplistic to say the least, particularly in today's strong economy.

In fact, for disciplined investors who know what to look for, higher rates can present valuable pockets of opportunity. Companies with low debt levels, for instance, tend to thrive in this kind of environment. Consumers in higher income brackets, meanwhile, benefit from booming home and equity prices, as well as higher distributions from fixed income securities — all of which supports spending. Instead of engaging in futile attempts to time the markets, professionals need to understand the environment we're in so we can better navigate it. Here's how you do that.

Fixed Income: Yields are still near two-decade highs

Granted, the "data-dependent" Fed of today, which reassesses with every economic news release, has generated a lot of volatility in the market for long-term bonds. In early April, for instance, inflation data came in hotter than expected. This lifted the 10-year Treasury 48 bps to 4.68% — within the top percentile of yields over the past decade. Then, just a couple of weeks later, soft employment data dragged yields back down to 4.5%.

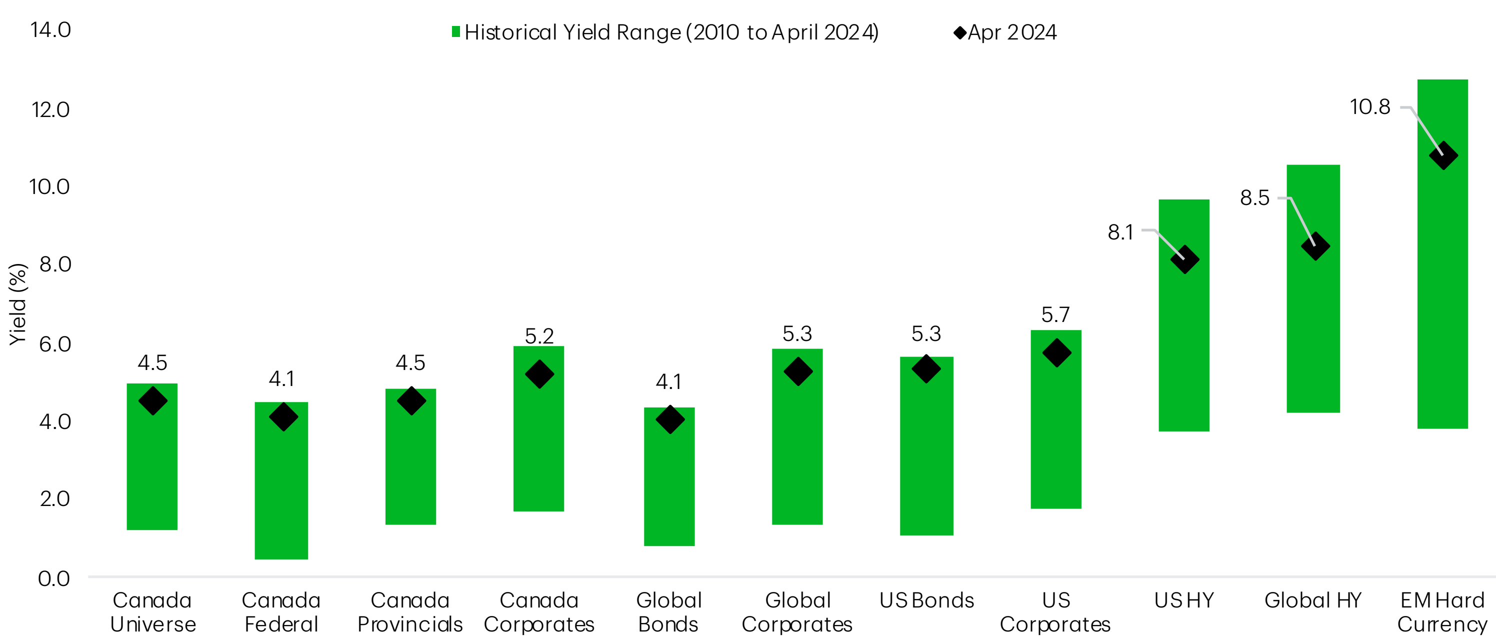
But if we can zoom out for a moment and look beyond the government bond-market turbulence — after all economic growth, inflation and geopolitics aren't going to resolve themselves overnight — we'll remember that yields are still near two-decade highs (Figure 2).

At current yield levels, fixed income should flourish. In fact, fixed income continues to offer the best opportunity in a decade.

High yields historically translate into higher returns, meaning the longer-term outlook for bonds is still attractive. At current yield levels, fixed income should flourish. In fact, fixed income continues to offer the best opportunity in a decade to build diversified portfolios. And if yields slide any further, they'll push up prices and add capital gains to total returns. Overall, high yields for a longer period of time is positive for bond investors, giving them an opportunity to earn high income and more cushion for any unexpected rise in yields.

When it comes to government yields, there's still no straight path forward. We believe central banks will err on the side of caution, limiting the size of rate cuts or delaying them or possibly both. Policy rates are likely to remain in restrictive territory and, even though Canada may cut rates before the U.S., the divergence will be limited. Canada and other developed markets outside the U.S. still can't rule out a more difficult landing than currently anticipated.

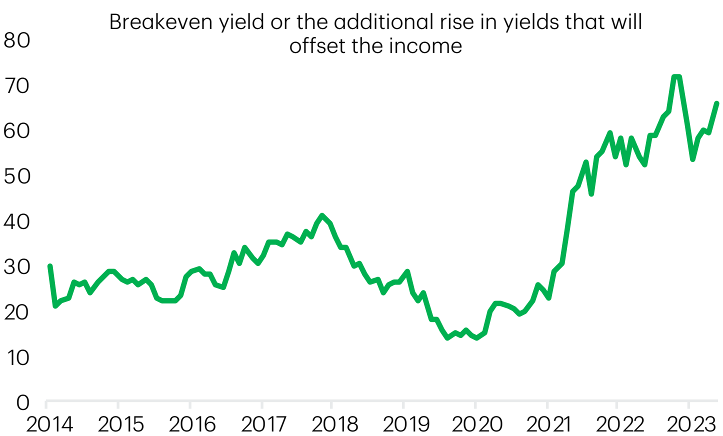
Figure 2: Yields still high across the board



Source: FactSet, WIO as of April 30, 2024

Although it may be tempting, the uncertain environment makes timing a trade in anticipation of a rate cut very difficult. Therefore, we think it's better to take a longer-term view on government yields and the broader interest-rate-sensitive Canadian fixed income universe. From a valuation perspective, bond yields are undeniably higher than the recent past and therefore offer more cushion (Figure 3).

Figure 3: Higher rates offer cushion from yield spikes



Source: FactSet, WIO as of April 30, 2024

The appeal of short-term credit

With government yields likely to remain higher than pre-pandemic levels for the coming months, the window of opportunity is still open for investors to take advantage of historically high yields and inverted yield curves. Shorter-maturity corporate bonds, in particular, offer high income and should also benefit from the gradual normalization of the yield curve over the coming months. Herewith, a rundown of some of the key advantages inherent in short-term credit:

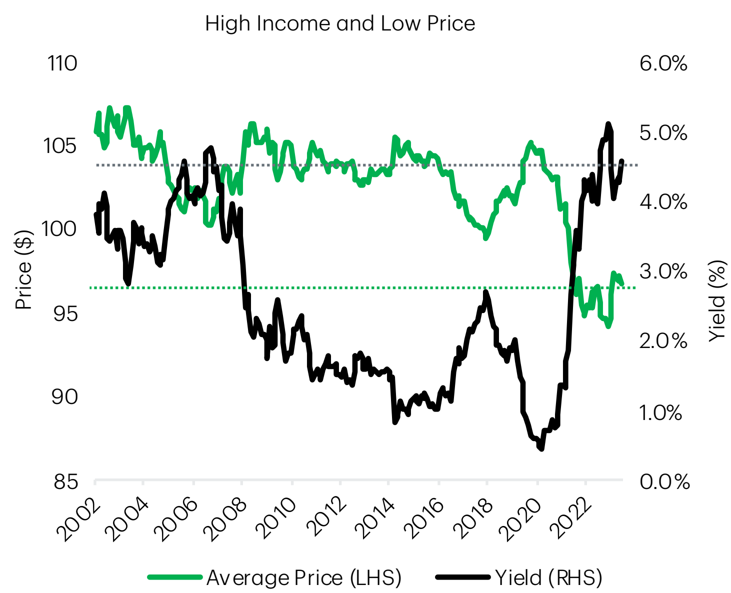
- **Capital Preservation:** The broad Canadian bond index suffered a significant 11.7% drawdown in 2022 due to its much longer duration profile, whereas the short-term bond index had a drawdown of just 4% over the same period. Both indices are considered high-quality, but the broader universe has been much more volatile because of its higher sensitivity to rate expectations, which have been shifting rapidly. Short-term bonds, by contrast, are less sensitive to rate expectations, allowing for less volatility and a greater ability to preserve capital.

- **High Income:** We believe the value proposition of owning short-dated corporate bonds as a total-return product is attractive; they now offer close to the highest all-in yield since the late 1990s, excluding the 2008/2009 recession (Figure 4).

- **Tax Advantage:** The short-term corporate bonds currently on offer were mostly issued in the near-zero-rate environment, and therefore at a very low coupon. But due to the increase in yields over the past two years, the price of these bonds has dropped considerably, with the vast majority trading at a discount (i.e., below par). The average price of the short-term bond index with a face value of $100 is now below that figure, which is near the lows of 2000. Therefore, when the bond matures at $100, the investor is looking at considerable capital gains. Hence, the overall returns on such bonds can be advantageous from a tax perspective.

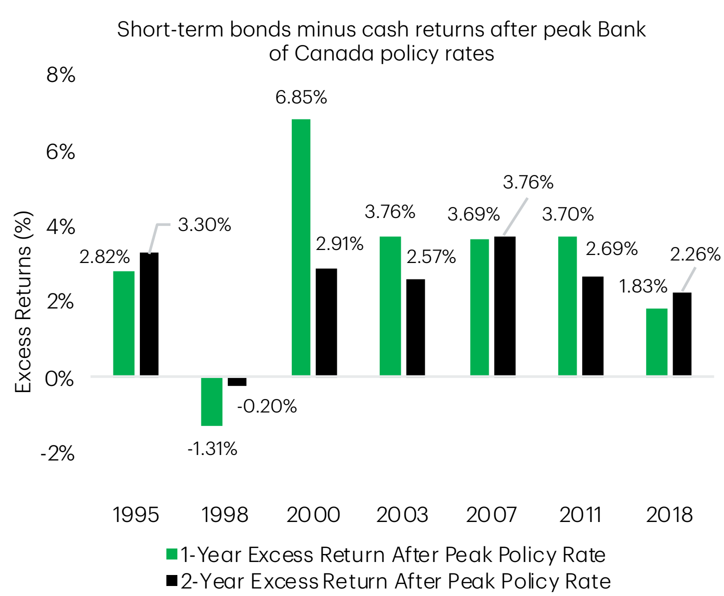
- **Outperforms Cash**: Cash yields are also attractive right now but won't remain so. As soon as central banks show signs of policy rate cuts, the simple interest on cash drops while the value of bonds or fixed income investments appreciates (because prices rise as yields fall). This explains why, historically, cash has underperformed fixed income in periods following peak policy rates (Figure 5).

Figure 4: Income and prices not seen since early 2000



Source: FactSet as of May 7, 2024

Figure 5: Cash was king, but maybe not for long



Source: FactSet as of May 7, 2024

Equities: Picky, picky, picky

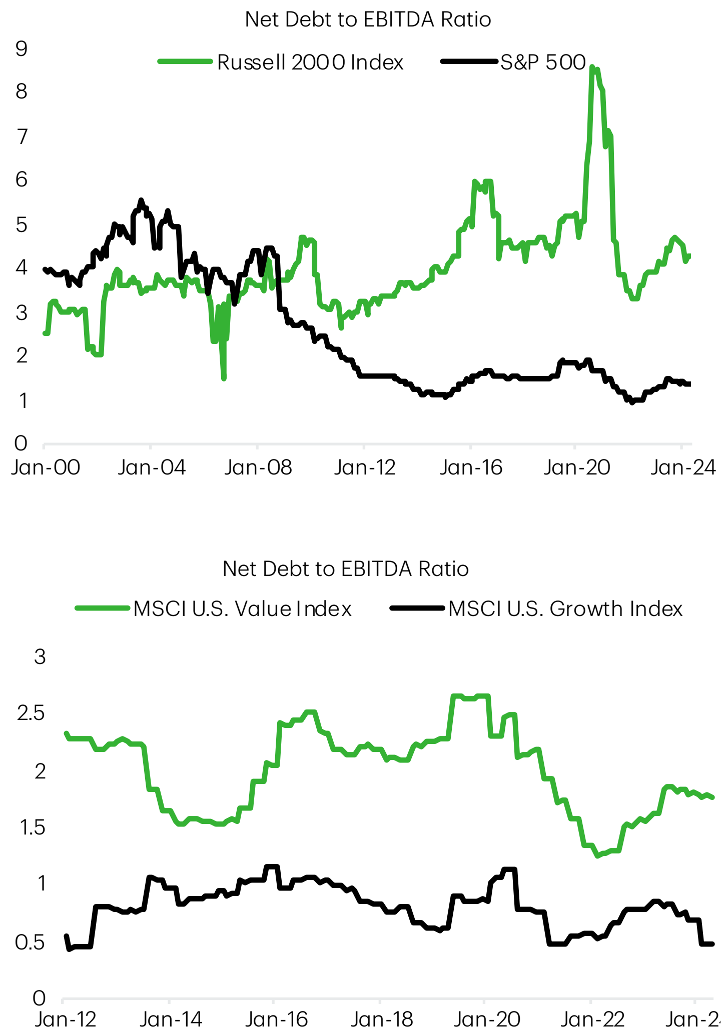
The first thing to note with respect to equities is that companies today are in much better shape than before the pandemic. That's because, from mid-2021 to mid-2023, companies dealing with extreme inflationary pressures took the opportunity to tighten their belts — by reducing headcount, refinancing at low rates, minimizing capex — all in order to extract operational efficiencies. Large-caps during this period increased their operating and net margins to 15.1% and 11.6%, respectively, from the historical averages of 13.8% and 9.0% (Figure 6).

Those margins remain healthy, so we're not all that worried about whether companies can still be profitable in a high-interest-rate environment. And while it's true that consumer spending could weaken in coming months, a strong labour market and higher wages should help to keep U.S. consumers spending overall.

Companies with strong growth characteristics — commonly found in the tech, health-care and consumer discretionary sectors — will have an advantage in a high-rate environment.

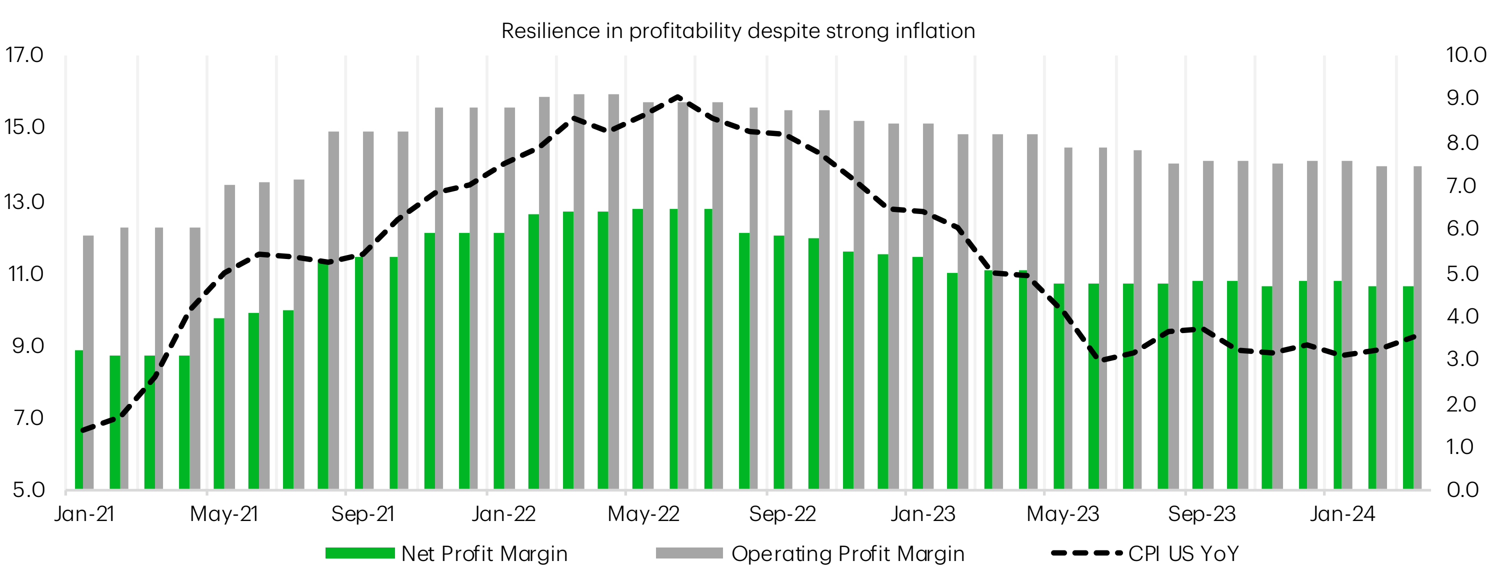
Large-caps will undoubtedly have an advantage in this environment because these companies tend to have a much lower ratio of debt to earnings (Figure 7) and are therefore less affected by higher debt-servicing costs. What's more, because large-caps tend to skew towards higher-grade bonds with longer maturities, they have less need to refinance in the short term. Small-caps in the high-yield space, on the other hand, tend to issue bonds with only two to three years maturity, so many of these will soon hit a refinancing wall.

Figure 7: Large-cap, growth stocks carry much less debt



Source: FactSet, WIO as of May 9, 2024

Figure 6: Companies are leaner today



Source: FactSet, WIO as of May 10, 2024

Similarly, companies with strong growth characteristics — commonly found in the tech, health-care and consumer discretionary sectors — will have an advantage in a high-rate environment. These companies have been generating healthy free cash flows this year, allowing them to pay down debt and initiate share buyback programs. Growth stocks have seen a decline in debt-to-earnings ratios alongside improving returns on capital.

A Caveat on Big Tech

The low-debt advantage enjoyed by large-caps is even more pronounced for the mega-caps. Apple, Google, Meta, Microsoft and Nvidia all have negative net debt, with cash balances greater than their total interest-bearing liabilities. This means funds held in cash and other short-term deposits are now accruing more interest for them.

But some caution is warranted here. The reality is that the euphoria around the AI narrative has led some of these mega-caps to have been overbought, many with stretched valuations. Investors, for example, are continuing to pile into the semiconductor space (the PHLX Semiconductor Sector is up 13% year-to-date), while software names that were early movers in AI are having a rather tepid performance so far this year (iShares Expanded Tech-Software Sector ETF down 1.4%, Figure 8).

The lack of a meaningful "bump" in the 2024 revenue outlook for these big software names may be one reason. However, this reporting season has presented an additional twist that helps explain their underperformance. In their Q1 earnings reports, a number of big software names (including Meta) committed to increase their investment in AI applications — only to see their stocks fall hard the next day.

This can be seen as a Catch-22 of sorts. On the one hand, investors are willing to factor in the time required for software companies to launch new AI products and services that will start to generate revenue in 2025. On the other, they're reluctant to underwrite any investments required to support the new product cycle. In short, investors expect AI revenue to accelerate but do not want to see companies increase capital expenditures to support it.

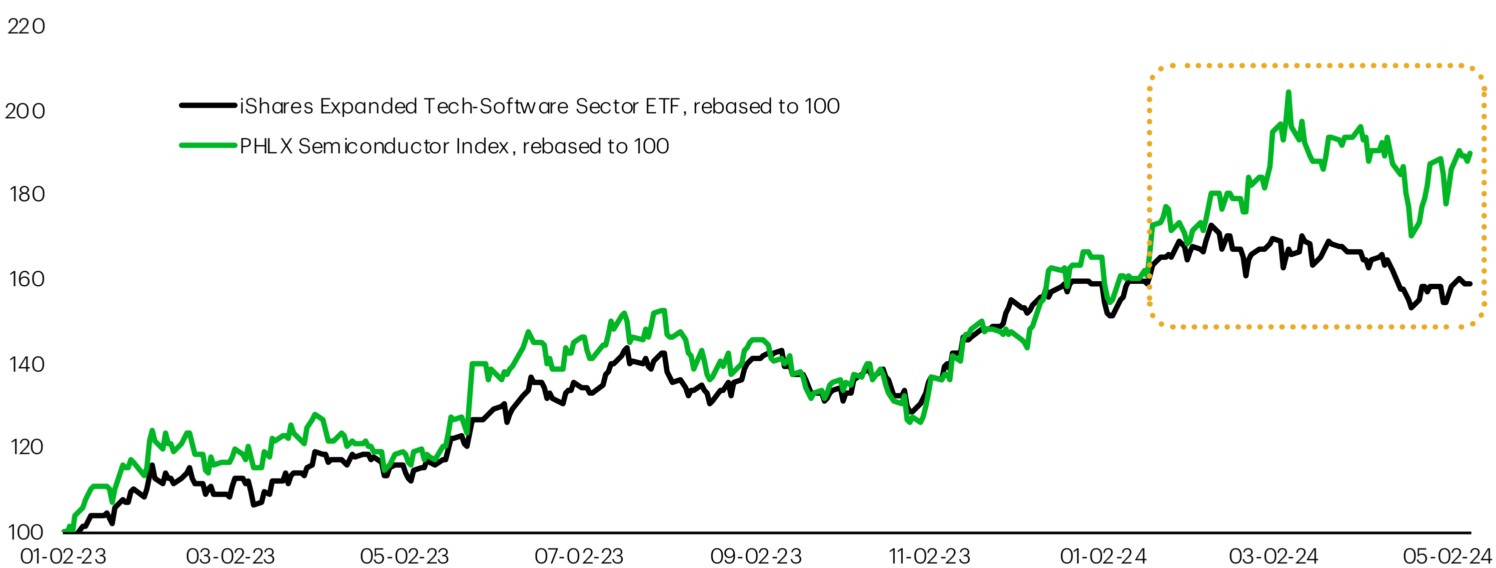
This has a lot to do with the current rate environment. In the decade or so following the global financial crisis, ultra-low rates made it easy for companies to commit capital for multi-year projects. Today, with rates vastly higher, it's much harder to make that kind of commitment. As a result, a lot of investors are reaching for the same low-hanging fruit — companies that can deliver returns with minimum amount of capital deployed. Hence, the interest in semiconductor names like Nvidia.

This approach creates the risk of an asset bubble in semiconductors, while ignoring the companies that are best positioned to capture the compounding effect of AI. But because the cost of capital is higher in the current rate environment, investors seem to be acting against their own long-term interests. This, in turn, allows active investors to capture the returns ignored by a market that's been coddled by the ultra-low-rate environment of the past.

Regional Policy Divergence

Regional distinctions are also important to note in an environment with high interest rates. In emerging markets with weak economies, central banks would love nothing more than to slash their interest rates to stimulate growth, but the extent to which they can do so is limited. That's because any move that diverges too widely from the Fed's leadership would risk a sharp depreciation of their local currency. That leaves companies in emerging markets to muddle through the headwinds created by higher-than-desired domestic rates.

Figure 8: Impatient investors lift semiconductors



Source: Factset as of May 10, 2024

In the developed world, meanwhile, major central banks have more freedom to diverge from the Fed. The Swiss and Swedish central banks have already begun to cut rates, and we expect the European Central Bank and the Bank of Canada to follow suit in June or July.

This, in turn, should create marginal opportunities for investors. While the stronger American economy should lead to a more attractive U.S. equity outlook, elevated rates will lead to higher long-term yields. Conversely, policy divergence is putting upward pressure on the U.S. dollar (Figure 9).

Finally, for export-dependent East Asian countries, the strong U.S. dollar has become a real headache. Last month, the Japanese and South Korean finance ministers met with U.S. Treasury Secretary Janet Yellen to address the recent depreciation of the yen and the won, likely opening the door to intervention in order to prevent the dollar from appreciating too much and too fast. Meanwhile, the Bank of Japan has expressed willingness to further raise interest rate if the weak yen feeds into higher inflation, given the country's dependence on imports of energy and food.

Old habits die hard

In the low-rate regime, investors acquired the bad habit of watching the Fed — and doing so was understandable to some extent. When 50 bps can double debt-servicing costs, every policy adjustment can feel like life or death. But what was once a habit is now a vice and not a good one.

While there's no telling when the central bank is going to pull the trigger on rate cuts, we can be reasonably certain that another hike is off the table, at least according to Chairman Powell's commentary in May. In addition, a weakening (but still strong) U.S. labour market shows that high rates are doing their job and cooling the economy, which should eventually pull inflation towards the Fed's 2% target.

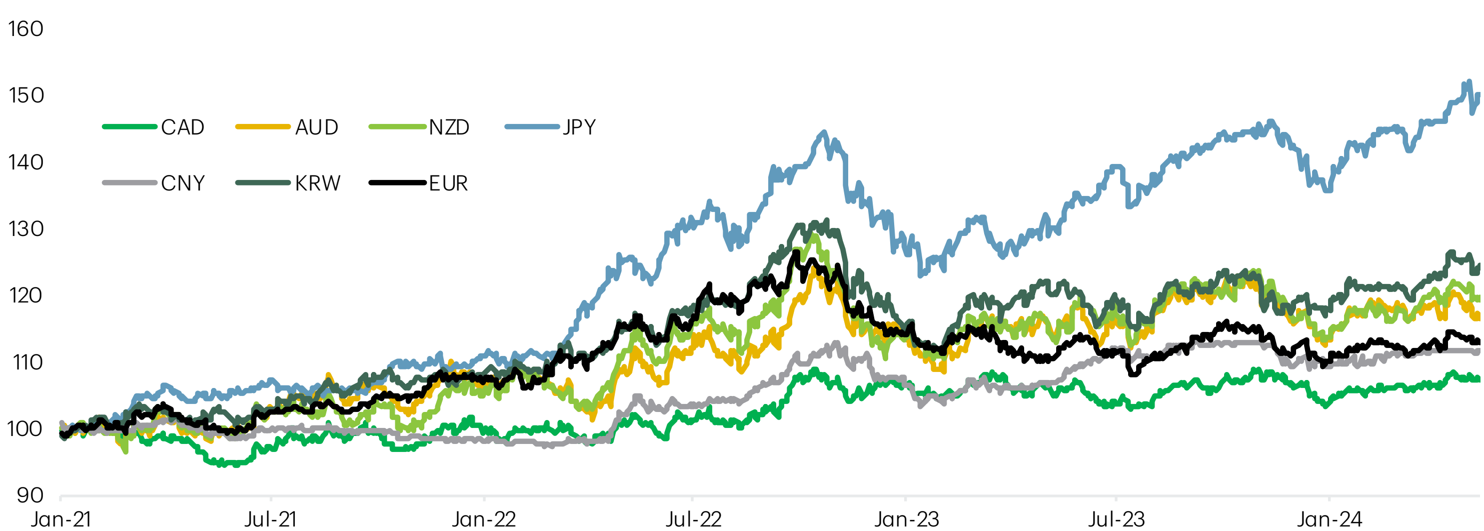
At current levels fixed income continues to offer the best opportunity in a decade. And if — and I mean if — yields slide any further, they'll push up prices and add capital gains to total returns.

Until rates start coming down, financial markets are bound to be jittery, but that's not a bad thing. Markets — both fixed income and equity — are supposed to have a bit of an edge. There is supposed to be some uncertainty around unknown variables. That's what makes them healthy, as opposed to ones driven by a singular factor: namely the direction of interest rates.

At current levels fixed income continues to offer the best opportunity in a decade. And if — and I mean if — yields slide any further, they'll push up prices and add capital gains to total returns. Returns may be volatile over the short term but they will accrue for those with longer time horizons — especially if fixed income portfolios are managed actively.

The same is true for equities. The S&P 500 implied correlation index has moved to the lowest level since 2023 and the dispersion index has been moving up so far this year. Both indicate that individual stocks are becoming more volatile and less correlated. Both are consistent with a market that's broadening out, which tends to be favourable to active management and stock-picking. The point is that there are pockets of opportunity to build diversified portfolios that drive good risk-adjusted returns and are not reliant on low interest rates. Its high time that we be reminded of that.

Figure 9: USD has outperformed all major currencies



Source: FactSet, WIO as of May 9, 2024

Market Performance

Canadian Indices ($CA) Return	Index	(%) 1 Month	(%) 3 Months	(%) YTD	(%) 1 Year	(%) 3 Years	(%) 5 Years	(%) 10 Years	(%) 20 Years
S&P/TSX Composite (TR)	87,969	-1.82	4.10	4.68	8.73	7.59	8.86	7.22	7.88
S&P/TSX Composite (PR)	21,715	-2.04	3.29	3.61	5.22	4.35	5.54	4.01	4.85
S&P/TSX 60 (TR)	4,304	-2.17	3.47	4.02	8.12	7.97	9.02	7.84	8.32
S&P/TSX SmallCap (TR)	1,369	0.17	8.50	8.10	9.69	2.64	7.92	3.57	3.98
S&P/TSX Preferred Share(TR)	1,876	1.22	4.80	10.96	14.60	1.33	4.44	2.09	2.69
U.S. Indices ($US) Return									
S&P 500 (TR)	10952	-4.08	4.29	6.04	22.66	8.06	13.19	12.41	9.94
S&P 500 (PR)	5036	-4.16	3.92	5.57	20.78	6.39	11.32	10.33	7.80
Dow Jones Industrial (PR)	37816	-5.00	-0.88	0.34	10.90	3.74	7.30	8.59	6.78
NASDAQ Composite (PR)	15658	-4.41	3.26	4.31	28.06	3.89	14.10	14.30	10.87
Russell 2000 (TR)	10572	-7.04	1.73	-2.22	13.32	-3.18	5.83	7.22	7.86
U.S. Indices ($CA) Return									
S&P 500 (TR)	15064	-2.54	7.11	10.44	24.50	12.21	13.77	15.00	9.98
S&P 500 (PR)	6927	-2.62	6.73	9.95	22.58	10.47	11.88	12.88	7.84
Dow Jones Industrial (PR)	52016	-3.47	1.80	4.50	12.56	7.71	7.84	11.10	6.82
NASDAQ Composite (PR)	21537	-2.87	6.05	8.63	29.98	7.88	14.68	16.94	10.92
Russell 2000 (TR)	14542	-5.54	4.48	1.83	15.02	0.54	6.37	9.69	7.90
MSCI Indices ($US) Total Return									
World	15,287	-3.67	3.74	5.01	18.96	6.14	11.00	9.45	8.54
EAFE (Europe, Australasia, Far East)	11,048	-2.46	2.73	3.33	9.84	3.39	6.70	4.88	6.12
EM (Emerging Markets)	2,718	0.47	7.92	2.92	10.33	-5.31	2.28	3.34	7.42
MSCI Indices ($CA) Total Return									
World	21,027	-2.15	6.54	9.36	20.74	10.21	11.57	11.97	8.59
EAFE (Europe, Australasia, Far East)	15,197	-0.92	5.50	7.61	11.49	7.35	7.24	7.30	6.16
EM (Emerging Markets)	3,738	2.05	10.84	7.19	11.98	-1.68	2.80	5.73	7.47

Currency									
Canadian Dollar ($US/$CA)	1.38	1.76	2.55	4.04	1.67	3.89	0.58	2.31	0.06
Regional Indices (Native Currency, PR)									
London FTSE 100 (UK)	8,144	2.41	6.73	5.31	3.48	5.33	1.88	1.85	3.09
Hang Seng (Hong Kong)	17,763	7.39	14.71	4.20	-10.71	-14.80	-9.77	-2.18	1.90
Nikkei 225 (Japan)	38,406	-4.86	5.84	14.77	33.09	10.05	11.53	10.38	6.34

Benchmark Bond Yields	3 Months	5 Yrs	10 Yrs	30 Yrs
Government of Canada Yields	4.95	3.87	3.82	3.67
US Treasury Yields	5.41	4.72	4.68	4.79

Bond Indices ($CA Hedged) Total Return	Index	1 Mo (%)	3 Mo (%)	YTD (%)	1 Yr (%)	3 Yrs (%)	5 Yrs (%)	10 Yrs (%)
FTSE TMX Canada 91-day Treasury Bill Index	457	0.46	1.24	1.71	4.98	2.78	2.07	1.46
FTSE TMX Canada Universe Bond Index	1086	-2.00	-1.86	-3.20	-0.91	-2.20	-0.11	1.75
FTSE TMX Canada All Government Bond Index	1018	-2.25	-2.31	-3.87	-2.15	-2.80	-0.63	1.45
FTSE TMX Canada All Corporate Bond Index	1,330	-1.24	-0.50	-1.18	2.79	-0.45	1.41	2.62
U.S. Corporate High Yield Bond Index	283	-1.01	0.37	0.32	8.08	0.92	2.96	3.70
Global Aggregate Bond Index	248	-1.69	-1.58	-1.82	1.12	-2.33	0.06	1.72
JPM EMBI Global Core Bond Index	500	-2.32	0.63	-0.68	6.63	-3.81	-0.72	1.95
S&P/TSX Preferred Total Return Index	1,876	1.22	4.86	10.96	14.60	1.13	4.49	2.07

Credit Suise ($US) Total Return	Index	1 Month	3 Month	YTD	1 Year	3 Year	5 Year	10 Year
Credit Suisse Equity Market Neutral USD	326	0.45	2.75	3.60	8.21	4.94	4.26	2.09
Credit Suisse Event Driven USD	857	-0.59	3.10	3.58	10.99	3.22	5.22	2.95
Credit Suisse Global Macro USD	1,396	-0.97	3.95	5.42	7.83	6.06	7.49	5.07
Credit Suisse Hedge Fund USD	820	0.16	4.00	5.47	11.09	4.98	6.13	4.34
Credit Suisse Long/Short Equity TR USD	1,032	-0.29	3.90	6.41	13.00	4.52	6.33	5.17
Credit Suisse Managed Futures USD	441	1.21	10.11	11.45	14.01	9.98	7.91	5.44

Source: TD Securities Inc., Morningstar®, TR: total return, PR: price return, as of April 30, 2024.

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