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Economic & Market Update

Bond Bull Markets & The Long Goodbye

Last month I wrote about the "Bond Market Vigilantes" and their re-emergence after 25 years. The appearance of vigilantes is generally bad for the bond markets as they threaten to sell their bonds if governments don't reign in spending.[1]

When there are generational turns in the stock or bond markets, old investment habits tend to linger.

It is often hard for humans to let go of what worked for so long.

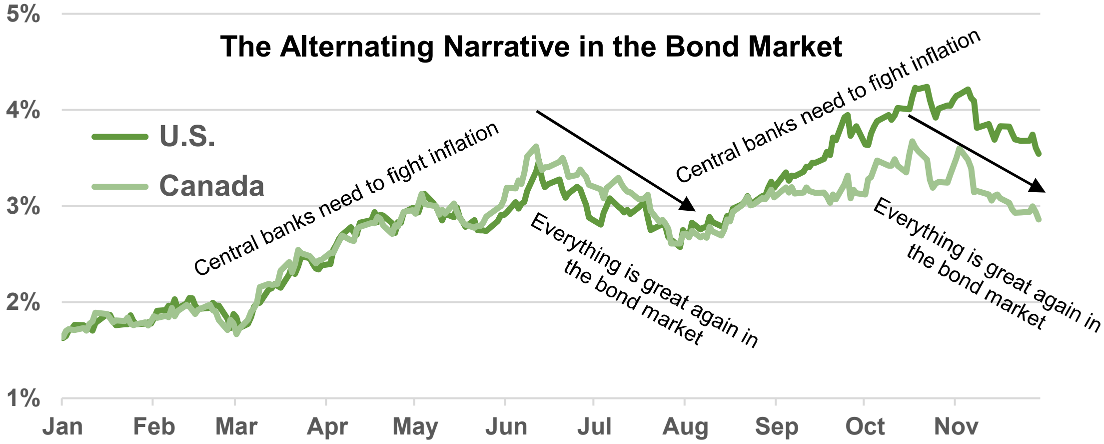
All this contrasts a growing narrative over the past month that the bond market has fallen enough that it now represents good value. Helping this narrative along has been the decline in interest rates since mid-October (**Chart 1**). This was also the prevailing argument during the summer when investors began hoping that central banks were getting close to the end of their interest rate hiking phase.

So, are we at the end of rising interest rates? Will a bond market recovery help the performance of bond funds? Are we heading back to a low inflation / low interest rate

[1] If governments spend more than they collect in taxes, they may have to flood the bond market with new securities. If that new supply outweighs investor demand, the prices of bonds will likely fall which will also have the effect of driving interest rates higher. The Vigilantes want to be ahead of this and sell early.

Chart 1:

10-Year Government Bond Yields from January 1, 2022



Source: Bloomberg Finance L.P. as of 12/5/2022

environment circa 2015? Anything can happen, but to me those scenarios have relatively low probabilities.

Recent bond market activity might be driven by a longing for the good ole days.

Bond investors are driving up prices and yields down hoping that inflation and the other challenges facing the bond market will be solved.

The recent drop in interest rates is premised upon the notion that the economy will slow down, reducing overall consumer demand and resulting in less price pressure, or lower inflation. Bonds tend to thrive in periods of low inflation, so investors are getting out ahead of this potential development by buying bonds. However, "acceptable inflation" is currently defined by central banks, including the U.S. Federal Reserve, the European Central Bank, and the Bank of Canada, as 2%. I have previously written about how the annual rate of inflation is expected to fall, but this is the result of the way that the annual inflation rate is calculated, and not necessarily the result of central bank policies. Basically, annual inflation was running so hot over the last year that when economists measure it going forward, they are measuring it against already high levels 12 months prior. It is hard to accelerate upwards if one is already starting from a lofty level.

The high-base effect is likely not sufficient to get us back to 2% inflation anytime soon. It might be safer to assume that we could level out at between 4% and 5%. The problem with that is it will still require bond yields and borrowing rates (mortgage rates) to remain elevated; lenders will want an inflation premium to protect them from the possibility of receiving devalued interest and principal over the life of the loan.

An additional problem with 4% to 5% inflation is that many of the business models that were behind the success stories over the last dozen years will be impaired or rendered ineffectual. Companies that thrived in the "free money, low inflation" world of the past may not have many options in the new environment.

Anything can happen, but many things would have to go right to quickly get us back to a stable bond market.

Keeping rates moderately high in order to keep a lid on inflation that remains entrenched at 4% to 5% would conflict with the current growing narrative that we are almost finished with the inflation battle and that calm bond markets and much lower rates are possible sometime next year.

In addition to these economic factors, there are also structural factors impacting the bond market. The biggest of these problems is trying to find enough bond buyers to soak up all the supply. If demand is insufficient, it might require higher interest rates to finally induce enough buyers into the market.

Perhaps bond investors should be asking:

How intrenched is inflation?

Who will be the buyers of bonds as central banks have gone from significant buyers to sellers?

How many new bonds will need to be absorbed by the market as governments continue to spend money they don't have?

Why do we suddenly need more buyers? Because supply has skyrocketed as federal governments around the world are issuing bonds to pay for all the pandemic aid spending. Also, the U.S. Federal Reserve has become a seller of bonds after 14 years of being a massive buyer. Then there's the Bank of Japan which is trying to offload a portion of its gargantuan holdings of U.S. Treasury bonds and using the proceeds to buy the yen which has been struggling against other major currencies.

The bottom line is that there is a significant increase in new bonds, *and* a significant increase in existing bonds coming back onto the market!

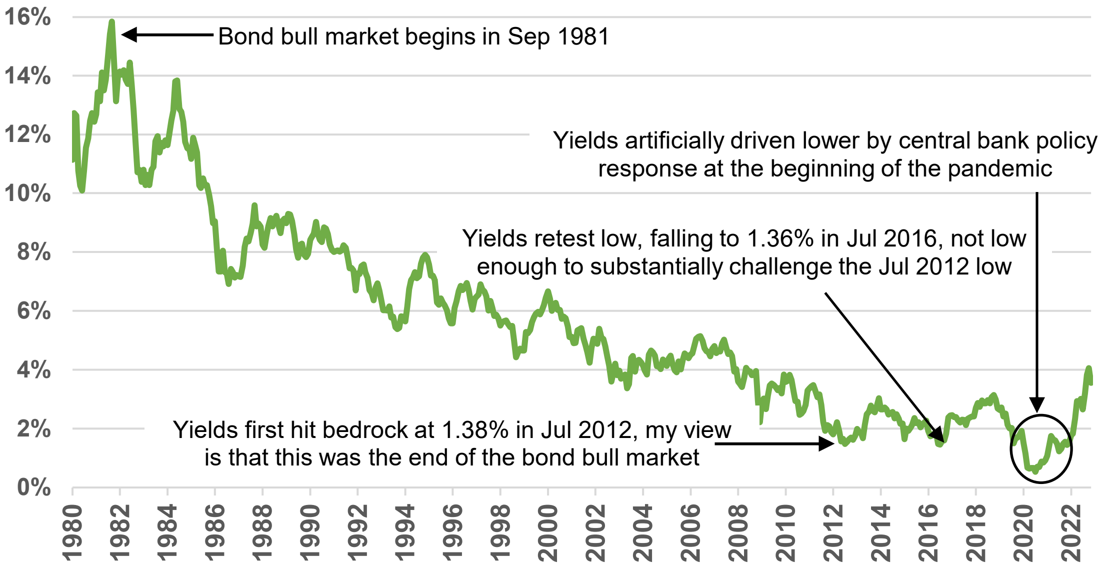
A final curveball is the increasing inability of the primary U.S. Treasury dealers to absorb the new bonds coming out and then to sell them to customers. The 24 institutions that have earned this privilege aren't much bigger than they were a dozen years ago whereas the amount of U.S. Treasury bonds coming to market is about triple what it was back then! There is a real potential of not enough interim buyers (dealers) *in addition* to not enough final buyers (investors).

Just as with any good or service, if supply overwhelms demand, the price needs to adjust to match buyers with sellers. In the case of the bond market, this equates to possible falling prices. And, if bond prices fall, their current yields will mathematically rise. For all the recent talk about a bond bull market, the potential for rising yields and interest rates would signify the opposite.

We as humans tend to long for the good times of the past. Sometimes this impacts our behaviours and decisions. It is hard to let go. Hard to say goodbye to what worked so well. We often see this after a long bull market in stocks. It is the same after a long bull market in bonds. However, my personal opinion is that the bull market in bonds, with the benefit of hindsight, effectively ended back in 2012 (**Chart 2**). That was when bond yields began to hit bedrock after generally declining since 1981. Yields dipped slightly lower in 2016, but did not significantly penetrate the 2012 low. The ultimate low in yields occurring at the beginning of the pandemic in 2020 was artificial from my perspective. Central banks backstopped the bond markets around the world. This was a policy response and had very little to do with the underlying market cycles.

Chart 2:

Yield on the 10-Year U.S. Treasury Bond since 1980



Source: Bloomberg Finance L.P. as of 12/5/2022

By some measures, we are now a decade into a bond bear market.

The last time bond markets switch from bear to bull in 1981, it took years for investors to accept the new reality and to take full advantage of the capital gains driven by falling interest rates.

Over the last 130 years, secular eras in the bond market tend to last about the length of a generation.[2] There are always short-term fluctuations in bond prices and interest rates, but the general direction of the trend over secular markets eras is pronounced.[3] Will the recent rally be one of these fluctuations within what might be a long secular bond bear market trend? When the realities of record debt, continued deficit-spending, increased interest rate costs of government debt, the excess money supply, the offloading of bonds by central banks and the bond market vigilantes hit investors, it will be interesting to see how long the optimism can last. Needless to say, we are keeping our bond maturities very short, and a significant portion of our bond interest income indexed to inflation.

[2] Homer, Sidney. (2005). *A History of Interest Rates* (4th ed.). Wiley.

[3] Secular Bond Bear Mkts: 1895-1920, 1946-1981, 2012-? Secular Bond Bull Mkts: 1920-1946, 1981-2012.

Model Portfolio Update[4]

The Charter Group Balanced Portfolio
(A Pension-Style Portfolio)

	Target Allocation %	Change
Equities:		
Canadian Equities	12.0	None
U.S. Equities	38.0	None
International Equities	8.0	None
Fixed Income:		
Canadian Bonds	22.0	None
U.S. Bonds	6.0	None
Alternative Investments:		
Gold	8.0	None
Silver	1.0	None
Commodities & Agriculture	3.0	None
Cash	2.0	None

The asset allocations and the securities holdings were unchanged during November.

No changes in the model portfolios during November.

All the asset classes we use were higher, led by international stocks.

For the month, every asset class that we utilize in the model portfolios was higher. Leading the charge were international stocks as the MSCI EAFE Index was up 10.2% in Canadian dollar terms.[5] International stocks have been the lagging performers so far in 2022 when compared to U.S. and Canadian stocks, so they were starting the month from a lower base. Canadian stocks were up 5.3% and U.S. stocks were up 4.6% in Canadian dollar terms.[6]

Some of this optimism is the result of a belief that central banks will pause their battle against inflation and will refrain from raising rates further by Spring 2023.

[4] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 12/2/2022. The asset allocations of individual clients invested in this Portfolio may differ because of the relative performance of the asset classes since the last rebalancing and because of differences in the timing of deposits and withdrawals. The Balanced Model Portfolio is part of a sequence of five portfolios ranging from conservative to aggressive: Conservative, Balanced Income, Balanced, Balanced Growth, and Growth.
[5] Source: Bloomberg Finance L.P. as of 12/2/2022.
[6] Source: Bloomberg Finance L.P. as of 12/2/2022. The S&P/TSX Composite Index used as a proxy for Canadian stocks, and the S&P 500 Index used as a proxy for U.S. stocks.

There were also bursts of investor excitement from the possibility that the People's Republic of China may begin to lift its pandemic lockdowns.

On both the prospects of pausing the inflation battle and the lifting of lockdowns in China, I sense that the market is getting ahead of itself. Optimistic investors may have to deal with setbacks if they realize that the timeline for those events could be further out into the future than anticipated.

Is the market getting ahead of itself?

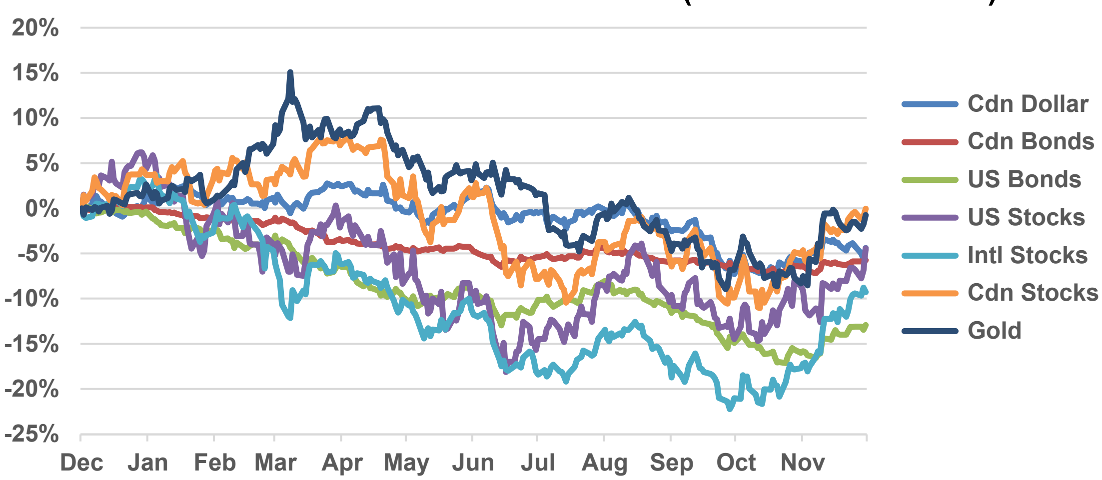
To determine this, we might have to wait until after a potential "Santa Claus rally" which is a seasonal factor that often occurs at this time of year.

In the meantime, this year-end rally might have a little more room to run. Seasonally, it is common to have a "Santa Clause rally" which tends to ride the positive holiday mood at this time of year. That said, the rally so far has not been the healthiest in terms of where investors are choosing to allocate their capital. Much of it appears to be going into sectors and companies that did well in the previous low inflation / low interest rate era. If the new era continues to reveal that it is different from the last one, those investments could quickly hit some turbulence.

Below is the 12-month performance of the asset classes that we have used in the construction of The Charter Group's model portfolios. (**Chart 3**).[7]

Chart 3:

12-Month Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. for the interval from 12/1/2021 to 11/30/2022

[7] Source: Bloomberg Finance L.P. – The Canadian dollar rate is the CAD/USD cross rate which is the amount of Canadian dollars per one U.S. dollar; Canadian bonds are represented by the current 3-year Government of Canada Bond; US bonds are represented by Barclays US Aggregate Bond Index; U.S. stocks are represented by the S&P 500 Index; International stocks are represented by the MSCI EAFE Index; Canadian stocks are represented by the S&P/TSX 60 Composite Index; Gold is represented by the Gold to US Dollar spot price.

Top Investment Issues[8]

Issue	Importance	Potential Impact
1. Global Geopolitics	Significant	Negative
2. Canadian Federal Economic Policy	Moderate	Negative
5. Inflation (Portfolio Impact)	Moderate	Positive
3. China's Economic Growth	Moderate	Negative
4. Canadian Dollar Decline	Moderate	Positive
7. Short-term U.S. Interest Rates	Medium	Negative
6. U.S. Fiscal Spending Stimulus	Medium	Positive
8. Global Trade Wars	Medium	Negative
9. Long-term U.S. Interest Rates	Medium	Negative
10. Canada's Economic Growth (Oil)	Light	Positive

[8] This is a list of the issues that we currently deem to be the ten most important with respect to the potential impact on our model portfolios over the next 12 months. This is only a ranking of importance and potential impact and *not* an explicit forecast. The list is to illustrate where our attention is focused at the present time. If you would like an in-depth discussion as to the potential magnitude and direction of the issues potentially affecting the model portfolios, I encourage you to email me at mark.jasayko@td.com or call me directly on my mobile at 778-995-8872.

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Accountability is further enhanced by the fact that we commit our own investable wealth to the same model portfolios in which our clients are invested.

The information contained herein is current as of December 5, 2022.

The information contained herein has been provided by Mark Jasayko, Senior Portfolio Manager and Senior Investment Advisor, TD Wealth Private Investment Advice, and is for information purposes only. The information has been drawn from sources believed to be reliable. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance.

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