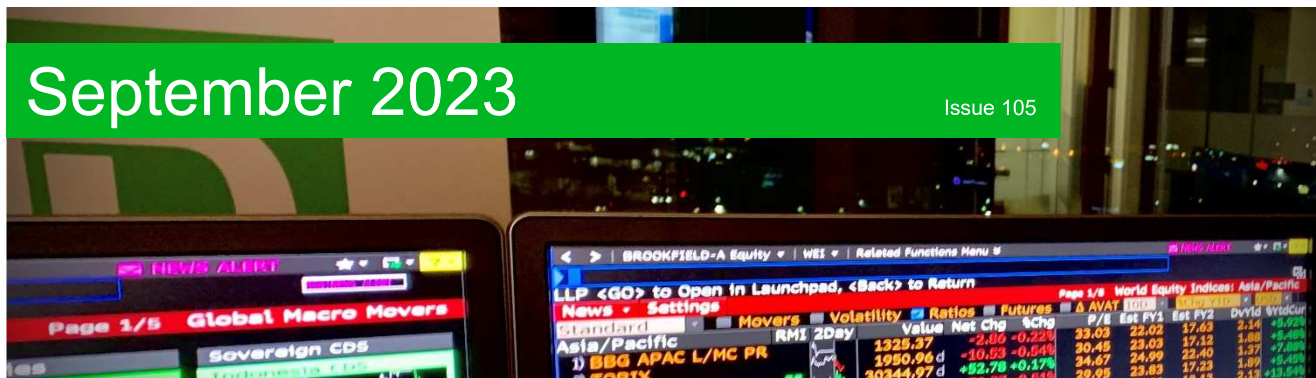
The Charter Group Monthly Letter



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Economic & Market Update

Was the Last Decade a Lost Decade for Bonds?

On July 24, 2012, the yield on the 10-year U.S. Treasury bond dipped slightly below 1.39%. This represented an almost 31-year journey from when the yield touched 15.84% on September 30, 1981. It was the greatest bull run in the history of the bond market (**Chart 1**). In addition to interest received over the period, the prices of existing bonds would rise, producing remarkable capital gains.

Back then, I personally remember the pessimism with respect to inflation and interest rates. There was no consensus that rates were about to peak and head lower over the next generation. In fact, it was so unexpected that when Henry Kaufman, at Solomon Brothers in New York, and the original "Dr. Doom", issued a forecast proclaiming that the future was looking bright, markets rocketed upwards.[1]

The challenges that bonds are facing recently have spurred talk of a bear market in bonds.

However, the last decade has generally been wasteland for fixed income investors.

Perhaps the bear market in bonds started a while back.

[1] Kaufman, H. and D.B. Sicilia. (2021) *The Day the Markets Roared: How a 1982 Forecast Sparked a Global Bull Market.* Matt Holt, Dallas, TX.

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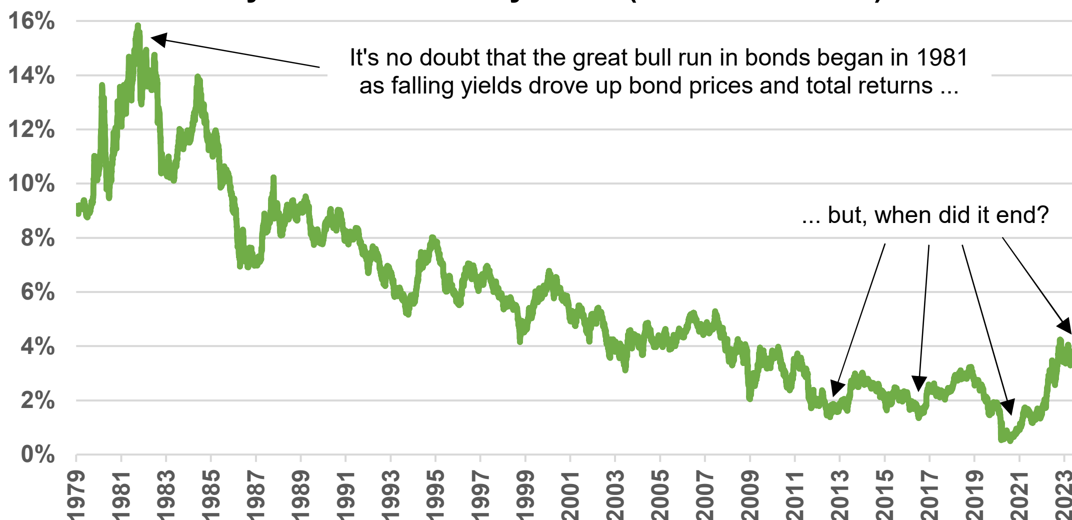
That fact that the August 1982 Kaufman memo had that kind of impact was a bit surprising as the yield on the 10-year U.S. Treasury bond had already fallen over 3% from its peak almost a year earlier. The U.S. was mired in recession from July 1981 to November 1982, but this had appeared to already be priced into stocks as financial conditions overall had eased. But it took Kaufman's forecast for investors to notice.

During the last generational change – when the bond market went from a bear to a bull – not many noticed for a few years.

Chart 1:
Yield on the 10-year U.S. Treasury Bond (1979 to Present)



Source: Bloomberg Finance L.P. as of September 5, 2023

Fast forward to today and one might question whether investors have yet to notice the change in the bond market beginning over a decade ago.

Last month I wrote in this newsletter about the confluence of factors that have somewhat unexpectedly depressed bond prices this year following an historically dismal year for bonds last year. In light of this, analysts are finally beginning to ask if we are heading into a bear market for bonds, including Jim Grant, the author of the bi-weekly *Grant's Interest Rate Observer*, and who is normally seen as perennially bearish on such matters.[2] Perhaps as a group, these commentators are acting as a surrogate for a modern day-Kaufman, pointing out the obvious and leading investors to realize that things have not been great in bonds for a long time.[3]

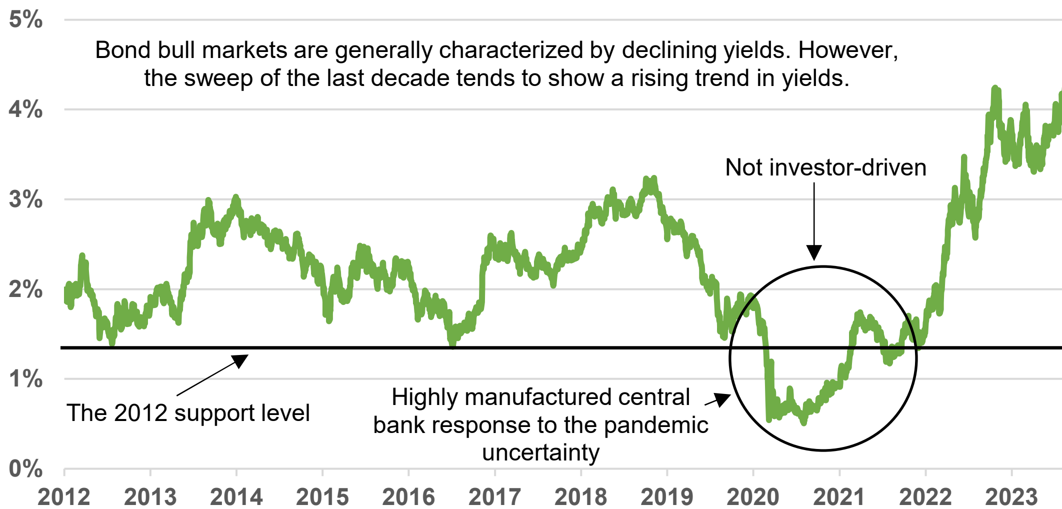
[2] Grant, J. "Higher for much longer." *Grant's Interest Rate Observer*. July 14, 2023. Vol. 41, No. 14. (Yes, I admit that publications like this constitute your portfolio manager's weekend reading list.)
[3] Kaufman is still around but is not really in the business of issuing specific forecasts anymore. Instead, he has been issuing warnings over the last two decades regarding a day of reckoning as a result of rising debt and a lack of regulatory reform. On another odd note, he will be turning 96 this October and attended the same high school as 97-year old Alan Greenspan (former Chairman of the U.S. Federal Reserve) and 100-year old Henry Kissinger (who was seen visiting CCP General Secretary Xi Jinping in Beijing last month). Apparently, the drinking fountain in the hallway at that school might have actually been the fountain of life!

What might be some of the observations that would confirm that bonds have been in a bear market since July 2012?

First, yields had difficult falling through that support level establish in 2012. In 2016, yields fell back to this level, but then bounced off and headed higher for the next two years. Then in 2019, they again approached this level, but bounced off yet again.

Chart 2:

Yield on the 10-year U.S. Treasury Bond (2012-Present)



Source: Bloomberg Finance L.P. as of September 5, 2023

Some might then point out that yields collapsed to historic lows with the onset of the pandemic in March 2020. However, I would argue that this decline in yields was manufactured by central banks who at the time said they would support the bond market at all costs. That support helped push up bond prices, which then got a further lift as investors saw them as a safe harbour in a time of uncertainty. Higher bond prices equate to lower rates. However, because I view that as being almost totally manufactured and not primarily the result of investor behavior, I am not going to count that 😊. I didn't at the time, and I am not going to know.

As a result, from my perspective, the July 2012 low in yields was the end of the 31-year bond *bull* market.

Yields have been bouncing along a bottom since 2012.

They went below this during the pandemic as central banks stated they would buy an infinite amount of bonds.

This artificial demand (non-investor demand) pushed yields below the 2012 levels for a sustained period.

If we factor out the rescue from central banks, the last decade has been a period of generally rising rates (a negative for the bond market).

Second, the general total return data for bond investors before and after July 2012 tell two very different stories (**Table 1**).[4] The iShares Core U.S. Aggregate Bond ETF (symbol AGG) was originally issued on September 26, 2003, and produced a total return of 5.16% annually compounded from then until yields bottomed on July 24, 2012.[5] The iShares Core Canadian Universe Bond Index ETF (symbol XBB) produced a total return of 6.61% annually compounded for the ten years ended July 24, 2012.[6]

The total return from bonds (which include the price change plus the interest received and reinvested) has been dismal since 2012 compared with the decade before.

Table 1: **Compounded Annualized Total Returns**	**Total Return** **Pre-July 24, 2012**	**Total Return** **Post-July 24, 2012**
iShares Core U.S. Aggregate Bond ETF	5.16%*	1.05%
iShares Core Canadian Universe Bond Index ETF	6.61%**	1.39%

* From September 26, 2003
** From July 24, 2002
Source: Bloomberg Finance L.P. as of September 5, 2023

Then, from July 24, 2012 until today, AGG and XBB produced annually compounded total returns of 1.05% and 1.39% respectively![7] Do those sound like "bull market" bond returns? Not to me.

The post-2012 period has the characteristics of a bear market in bonds.

If we are over eleven years into this bear market in bonds, is the end near? Will bonds become significant contributors to overall portfolio returns again sometime soon?[8]

The recent acceleration in rates has merely heightened investor attention to the reality that the bond market is struggling.

Unfortunately, bull and bear markets in bonds tend to run for two or three decades. So, we might have at least another decade to go before this bear phase plays out. As I wrote about last month, it might not be until the Millennials have surplus capital to invest, which I estimated would take about a dozen year until they take the baton from Generation X in this regard.

Until then, we may have to endure an era of higher interest rates and lower bond prices.

[4] Total returns for bonds include both the price performance, plus interest received, and the reinvestment of that interest. This assumes that the interest was re-invested back into those bonds rather than being spent on something else. If we only looked at the price performance of the bonds using the two main bond market ETFs for Canada and the U.S. since July 24, 2012, the returns would actually be negative!
[5] Source: Bloomberg Finance L.P. as of September 5, 2023.
[6] Ibid.
[7] Ibid.
[8] We have held bonds in the model portfolios over the last decade as insurance against significant and sudden disruptions in stock markets, not because of their return potential. If we entered into a bull market for bonds, I would begin to look at bonds to supplement the returns that we get from riskier assets in the portfolios instead of solely as a risk management tool.

Model Portfolio Update[9]

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 specific securities holdings in the model portfolios remained unchanged in August. However, at the beginning of the month, all the model portfolios were subject to a rebalancing that brought all the positions back to their original targets. This allowed us to take some of the profits from the winning positions and redistribute them to the positions that we still want to hold.

Apart from a re-balancing at the beginning of August, there were no changes to the model portfolios during the month.

Most of the asset classes were flat to down over the month as a sense of uncertainty permeated the markets with respect to the future direction of interest rate policies, economic growth, and inflation. Investors looked ahead to the U.S. Federal Reserve's symposium in Jackson Hole, WY. However, even that event failed to clarify things much.

Inflation concerns and central bank policies have maintained investor uncertainty.

If anything, the most noteworthy thing during August was the rising yield on the U.S. 10-year Treasury bond which clashed with a consensus view that the economy would experience a soft landing and that inflationary forces were ebbing. Perhaps rising longer-term yields are telling us the outcome might be a little different than what the consensus

Longer-term bond yields have continued rise, especially in the U.S.

[9] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of September 5, 2023. 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.

currently expects. Stubborn pockets of inflation and rates that will be higher for longer perhaps?

Higher U.S. interest rates have been bad news for the Canadian dollar.

One casualty of levitating U.S. Treasury yields was the Canadian dollar which has lost over 2 pennies versus the U.S. dollar since the beginning of August.[10] Foreign investors were attracted to the higher returns on U.S. government debt, which often increases the demand for the U.S. dollar at the expense of other currencies such as the Canadian dollar. Also, there appears to be some provincial political solicitation aimed at the Bank of Canada not to raise rates further. Will the Bank of Canada feel the pressure, despite being independent, and keep the Bank Rate where it is? If so, it might be a recipe for further Canadian dollar struggles.

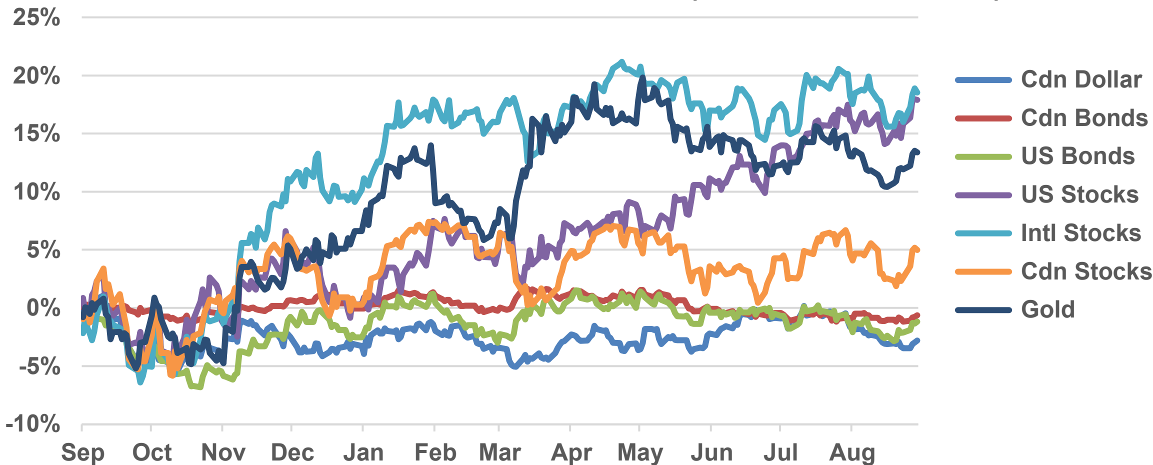
If corporate earnings don't improve, it could be difficult for the market to rise if the artificial intelligence hype abates.

As we head into the autumn, there could be greater scrutiny on corporate earnings to justify current valuations. The AI Hype Machine has done most of the heavy lifting this year. It is reasonable to expect that the rest of the equity universe will need to pitch in to lift markets higher over the near term. Will valuations outside of the Magnificent Seven AI stocks be appealing enough to attract investors into the rest of the market? If not, we could get a rise in market turbulence, which is often a characteristic of this time of year.

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**).[11]

Chart 3:

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



Source: Bloomberg Finance L.P. for the interval from September 1, 2022 to August 31, 2023

[10] Source: Bloomberg Finance L.P. as of September 5, 2023.

[11] 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[12]

Issue	Importance	Potential Impact
1. Global Geopolitics	Significant	Negative
2. Canadian Federal Industrial 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. Long-term U.S. Interest Rates	Medium	Negative
9. Global Trade Wars	Medium	Negative
10. Canada's Economic Growth	Light	Positive

[12] 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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The Charter Group is a wealth management team that specializes in discretionary investment management. For an annual fee, we manage model portfolios for private clients and institutions. All investment and asset allocation decisions for our model portfolios are made in our Langley, B.C. office. We do not outsource any of the decision-making for our model portfolios – there are no outside actively-managed products or funds. We strive to bring the best practices and the calibre of investment management normally seen in global financial centres directly to the Fraser Valley and are accountable for the results.

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 September 5, 2023.

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