May 2022

Investor Strategy

The latest market insights from Richardson Wealth

Fixed income

Executive summary

1. April market recap
2. Fixed income portfolio construction
3. Market cycle view

Note: given the market volatility in late April, we published an off-cycle Market Ethos on April 28 encapsulating our thoughts. Sometimes we just can't wait for the end of the month to put pen to paper, markets don't necessarily follow the Gregorian calendar. In case you missed it: (Click HERE for Market Ethos: Correction goes warp speed)

This month, the nature of the downdraft in markets gives us a good opportunity to revisit the portfolio construction theme. While the markets deserve their splatter of pixels (which we give briefly in the market recap), we focus on the fixed income portion of the portfolio.

Given we are seeing the worst drawdown in bonds in decades, we will review why we own bonds, what value they add to a portfolio, and what factors go into selecting the portfolio components.

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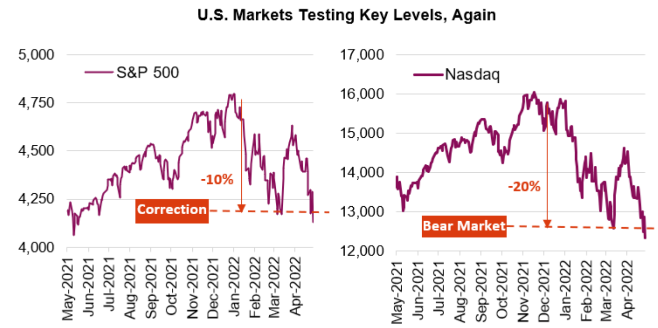
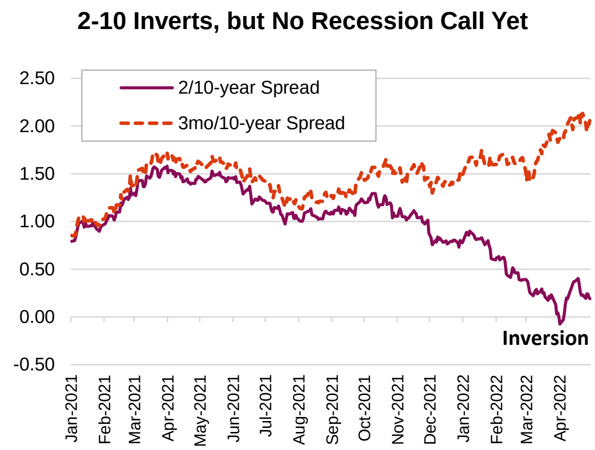
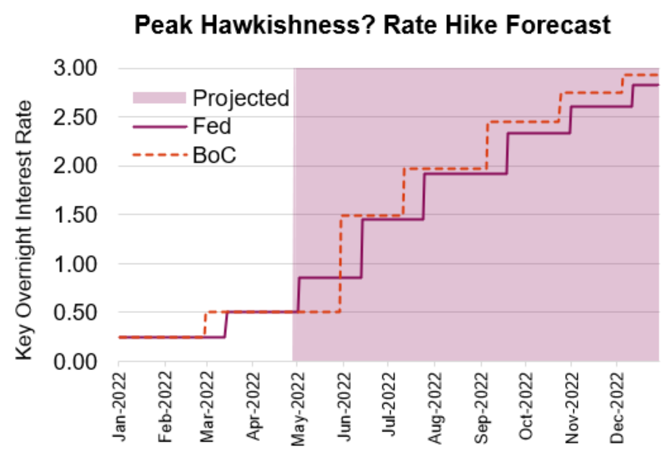
April showers …

After the bond market whispered the "R" word with the 2-year–10-year yield curve inverting, the April showers came and no market was spared. U.S. equities, with their heavy weighting in technology, were under significant pressure and closed out on the lows with even the formerly resilient mega-cap FAANG stocks beaten down on weak earnings. The resource and financials-biased TSX, which was enjoying a positive 2022, could not escape "April showers" and saw the majority of its gains washed away. The TSX ended with an April total return of -5.0% while the S&P 500 shed 8.7%. Back to the "R" word for a moment. Despite the inversion, we are looking for some more evidence from the yield curve and other factors before we start waving the recession flag. There is a special *Market Insights* focusing on the yield curve as an indicator coming soon, so stay tuned.

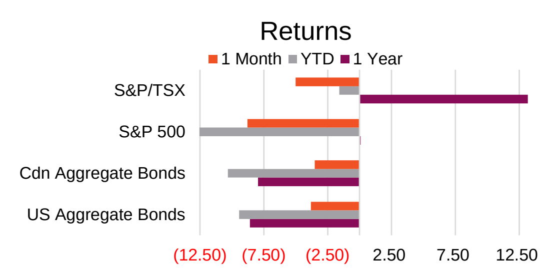




One would think with equity markets performing so poorly that bonds would have rallied. Think again. Rate hike expectations, inflation prints, and economic stats made it tough for fixed income as well. The yield on the 10-year U.S. Treasuries reached levels not seen in four years, rising to nearly 3%. In Canada, you need to go back *eleven years* to see the same level of yield on the benchmark bond. Corporate spreads moved wider in a hurry, as they tend to do alongside equity weakness, making the overall bond markets wind up with a loss of 3.5% in Canada, and 3.8% in the USA. This pushes the losses into double digits for the bond universe this year, one of the reasons we will be talking about bonds in this issue – so more on this later.



The Bank of Canada moved 50bps in April, and while the Fed did not have a meeting during the month, there was plenty of "FedSpeak" suggesting that the May meeting could see 50bps or even a triple-down-75. As they closed the month, the futures market was pricing in a double, with a very small chance of a 75 bps. That being said, with up to ten hikes for the Fed and eight for the BoC now being priced for the remainder of the year, have we reached peak hawkishness?.



What's more? Glad you asked: The continued war in Ukraine carries on; weak earnings from the big companies (although 80% of companies that have reported so far have beat expectations, besting the five-year average of 77%); a continued pandemic lockdown in China creating supply chain uncertainty; terrible consumer sentiment; and an *all-time-low* in the AAII "Bullish" investor sentiment reading. Yes, lower than September 2008. Similarly, "Bearish" is at an all-time high. Wow, you would think the world had fallen apart. More on all this in the cycle view.

This will lead us to say ….

Take a breath!

Following numerous conversations with both investors and advisor, a common theme has emerged which we will paraphrase as follows – "*We own bonds for some income but mainly to provide a stabilizer for the portfolio during periods of equity market weakness. So far this year, the equity market is in correction mode and bonds are not helping, they are hurting. Should we throw out our bonds and reconstruct portfolios?*"

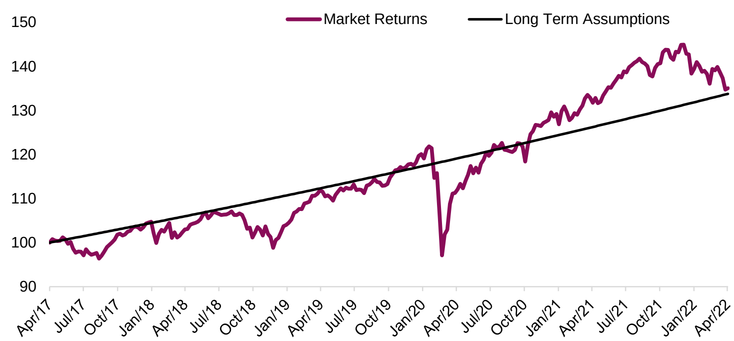
Let's just take a breath. As managers of balanced portfolios, we share this frustration. Hopefully your bond allocations are shorter duration, have more credit or have some alternative strategies that have held up better than the index. Most do. But let us not forget what bonds and equities did over the past couple years.

Let us assume long term equity returns are 7% and bond returns 4%. You can have higher assumptions if you like, but the takeaway from this exercise is the same. That means a 60/40 portfolio (60% equity, 40% bonds) should deliver about 5.8% annually. Some years will be higher, some lower. The last few years have been higher, materially so.

Annual returns for this balanced strategy have been: 2019: +16%; 2020: +9%; 2021: +12%. Pretty juicy returns! Or at least above norms. While bonds fell 3% in 2021 (we didn't notice behind the killer equity numbers), in 2019 they delivered +7% while 2020 gave us +9%, both above norms.

Our point? Put the recent weakness in prices into a longer-term perspective. Now that stimulus and spending are pivoting back to normal, so are returns. Stock and bond prices have reacted quickly, given the ease in which they change hands. Real estate may be a longer adjustment process but seems to be following the same course.

Asset prices got over inflated, both bonds and equities, now they are mean reverting to the long term trend



Source: Bloomberg, Purpose Investments

Market Returns = 25% Cdn Eq, 20% US Eq, 15% EAFE, 40% Cdn Bonds. Long Term Assumptions +7% Equities, +4% Bonds

This month, we are looking at bonds. Making sure your fixed-income allocations have a diversified approach including some plain vanilla, some active credit and some alternative strategies continues to be the best path forward. Thoughtful, well constructed portfolios remain critical during above average years with double-digit returns and in years with below-average negative returns.

There are many decisions to be made in the construction process, such as:

- Directly held or managed
- Active vs passive
- Credit concentration and geography
- Duration
- Liquidity

Let's break them down:

Directly held versus managed

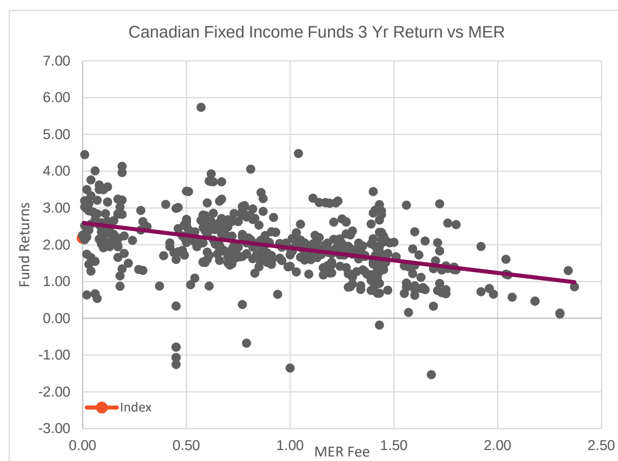
Holding bonds directly is an excellent, low-cost option. That said, it is not always practical, as the availability and liquidity of bonds is not always guaranteed, and there are thousands to choose from. When it gets into selecting from various issues, details matter. Issue size, bond indentures, liquidity, credit quality, seniority. All these factors and many more make selecting individual bonds a task for those with the time and knowledge to navigate the space.

There are hundreds of managed options, both actively and passively managed (see below). While picking a manager is often more practical than selecting individual bonds, you have to remember that a bond fund is perpetual, while individual bonds mature. Over a long period of time, this won't make a difference as returns will be similar. But optically, it is possible for a bond fund to decrease in price and stay there forever. If rates rise, a bond fund or ETF will fall in price, much like the bonds that they hold. *Unlike* a direct bond, however, there is no "par" or maturity value that they will revert to. Distributions will increase such that the total returns are equal (ignoring fees), but the price may stay lower. Many investors don't like these optics and opt for direct holdings as they will always, barring a default, start and finish their life at par.

Active & ~~vs~~ Passive

If choosing the managed or fund route, the next decision is active or passive. This goes beyond bonds and is important enough to deserve its own Investor Strategy. Look for that in the coming months.

Fees always matter. But when we are dealing with fixed income, they matter more. Unless you get into *very* active alternative strategies, the upsides of bond funds are limited, so the fees just eat into the fixed returns. This scatter plot of traditional bond funds versus their fees shows the obvious – the higher the fees the lower the return.

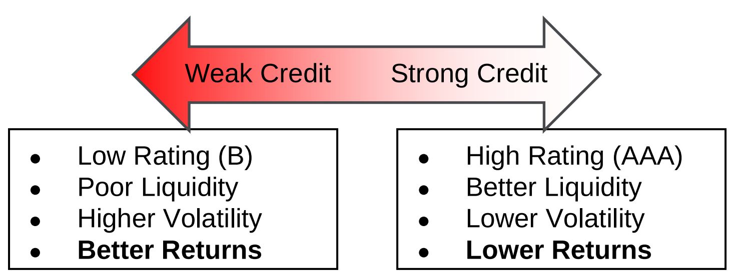


While we always want to minimize fees, active management can come with its benefits, especially when we get into the alternative world, where managers have the tools to accentuate and mitigate certain risk and return factors that individuals just don't have. The same can be said for less liquid markets, or assets that are harder to get. Being a large institution can open markets and make trading more efficient, mitigating the damage of fees in some cases. We would argue preferred shares fall into that category, for example.

Credit concentration and geography

In a way, credit and geography are the same discussion. Introducing anything but the highest-quality Canada bonds will increase both risk and potentially returns, to a domestic investor. We won't delve too deeply into currency exposure, but it is a significant factor in driving foreign fixed-income returns. FX has the potential to turn winners into losers and vice-versa. Most have a strong home-country bias in their fixed income allocations for a reason.

Credit is one of the factors in a portfolio that needs to be well thought out. Choosing bonds with lower credit, like corporate bonds, both investment grade and high yield, will increase the potential returns, but also the default risk and the liquidity risk. In addition, generally the lower you go into the credit spectrum, the more you need to worry about **covenants**. For those who want to dig in,



[we talk about bond covenants on our RWL podcast](), but safe to say that not all bonds are created equal, and investors need to understand the terms of the bonds they are buying. Since terms often change from one bond to the next, even when issued by the same company, credit investing can become very detail-oriented affair.

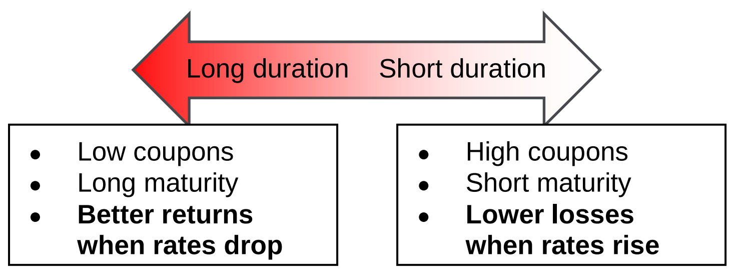
Duration

The concept of duration can sound complicated, but it is quite simple: Duration, measured in years, indicates the years it takes to get your initial investment back on a cash flow basis. If you invest $100 in bonds, it is a measure of how long it takes you to get that first $100 back in your pocket. High coupon bonds will lower the duration because those coupons lower the amount of time for you to get your initial money back. Short maturity bonds promise your principal back sooner, so they have a shorter duration as well. Duration also measures the price sensitivity of a bond to a 1% change in its yield. A bond with a duration of 4, for example, will rise in price by 4% if its yield drops by 1%. The opposite is true too, which is why longer bonds have had such big drawdowns despite small rises in yield.

Since Jan 1, 2022	Change in Price	Change in yield
Canada 30 year bond (2051)	-21.30%	+113 basis point
Canada 2 year bond (2024)	-2.65%	+167 basis points

For the past 40 years, longer duration has outperformed, but that is the result of a multi-decade secular bull market for bonds where rates have trended down. There is no guarantee that will continue, so long (and short) duration strategies are better for active, tactical trades rather than a strategic long-term position.

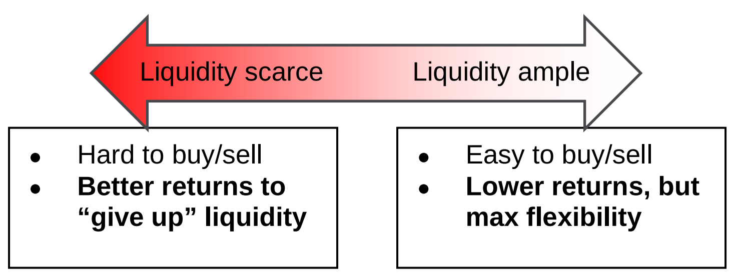
Lately, we have been favouring short duration, given that starting yields are so low. This has made for better (though still negative) outcomes this year as rates have risen. They didn't fare so well when we were early on the call and rates were still falling.



Liquidity

Liquidity is often overlooked. When investing for the long run, people often gloss over this factor because they look through periods of illiquidity and consider them irrelevant. We think that liquidity is potentially the most important factor in fixed income investing … or investing in general. Liquidity and ones' ability to provide it (or conversely need it) when it's scarce, can make or break an investment strategy. While this lends you to think of a disaster like a margin call blowing up a strategy, we would rather focus on the functional liquidity of a portfolio that allows you to rebalance when the opportunity presents itself.

While this section may lack some concrete examples, the simple function of strategically allocating liquidity will allow an investor to take advantage of illiquidity to earn extra returns, but also remain liquid to take advantage of market opportunities that are presented.



The examples would be investing in private credit funds on one side of the spectrum, giving up liquidity to earn more yield, and accepting a lower return in Canada bonds because they almost always remain easy to sell when needed. Similarly, one should think of their cash allocation as having more value than just its miniscule yield. The option to deploy it instantly is worth something: that value just won't be attributed back to the cash.

Putting it together

Given all these factors to consider, how do we put them into a portfolio? As usual, this depends on the investor, their goals and risk tolerances. In short, we would encourage one to consider return goals, ability to withstand drawdown and liquidity needs and opportunities. Understanding these will allow for the construction of a portfolio that can adapt through cycles and be flexible and robust enough to provide returns and adapt to changing markets.

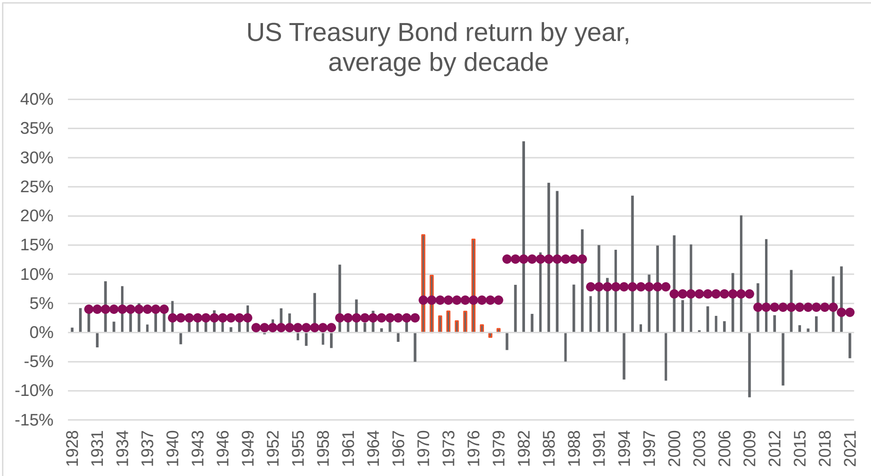
	Direct Owned No Fee	Passive Mgmt Low Fee	Active Mgmt High Fee
Structure	Direct Bonds	ETFs & Index Funds	Funds and Alternatives
Duration	Short and Long available in all formats		
Liquidity	Liquid and Illiquid available	Usually Liquid - stressed periods challenge	Potentially Illiquid

Investment Examples

	Higher Risk, Higher Return, Lower Liquiity		Lower Risk, Lower Return, Higher Liquidity
Credit	Private Debt, Pref Shares, HY Bonds	Inv Grade Bonds	Sovereign Bonds
Duration	Long dated/Low Coupon		Short Dated/High Coupon
Liquidity	Small issues, Private Credit		Large issues, listed debt

We aren't convinced of the environment, but a glance to the bond returns of the 1970s may provide a guidebook to what the variability of fixed income returns could look like. Sure, the average annual return in the decade was 5.6%, but remember that the average *yield* on the bonds was 7.5%, meaning that loosely speaking, the bonds lost 2% of capital each year, but made up for it in coupons. The starting point today is 2.8%, so the buffer of coupons is much reduced.

Our point? It will likely pay to stay nimble in this environment.

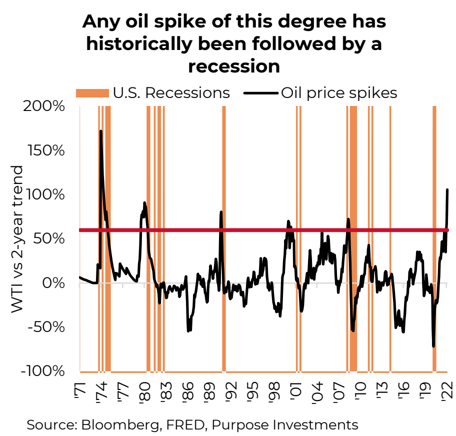


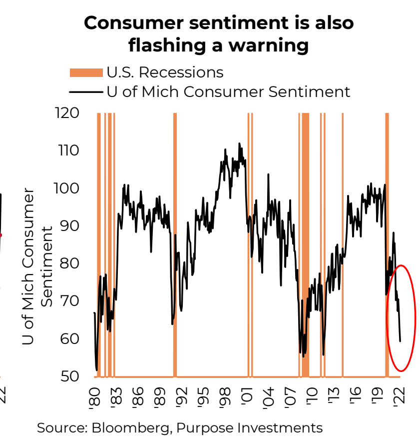
Market cycle: Reports of my death are greatly exaggerated

Yes, we are aware of the Mark Twain misquote, but with all the talk of a recession it does seem apropos. The current economic expansion is slowing for several reasons. The ongoing war in Ukraine, with its associated sanctions and impact on energy and food prices, is a clear headwind. This will be most apparent for the European economy given the proximity of the conflict, reliance on imported energy and greater sensitivity to global trade (relative to the US). Beyond Europe, higher energy and food prices are the equivalent of a tax on the global consumer, disproportionately impacting lower-income households who also have a higher propensity to spend. Inflation was present before the war erupted and prices have accelerated since. Add to this that most central banks are raising their respective overnight rates and longer-term bond yields are rising. For now, let's call these headwinds a Beaufort wind force 4, Moderate Breeze.

Grabbing additional headlines is several common rules of thumb that are flashing, or nearly flashing, a recessionary warning signal. The rapid rise in oil prices is one such culprit. Historically, spikes in energy prices of this degree have preceded U.S. recessions and global slowdowns (left chart below). The world consumes about 90 million barrels of oil per day, so even if paying 'crude' prices for energy, the $40 increase so far this year would be an annual $1.3 trillion tax on the consumer. Just to play some more with big numbers, the world economy is about $95 trillion. While this may make the $1.3 sound small, if that spending diverted from goods and services, the 1.4% drain over a year would be a big hit to aggregate growth. Looking at "Crack Spreads" is also worrying. The ratio of finished products (gasoline and diesel) to crude oil indicates that (American) consumers are paying even *more* for their energy – so our "crude" math above is conservative (see what we did there?)

Next is consumer sentiment, which recovered following the pandemic recession but has been degrading for a year now. Even before inflation and the war, the consumer was not happy despite strong job gains and rising wages. Maybe Covid makes people complain or maybe it's inflation. Whatever the reason, sentiment this low has coincided with or preceded recessions.





And then there is the yield curve. An inverted yield curve is perhaps the most popular recessionary canary these days and for good reason. The U.S. yield curve inverted before the 1974, 1980, 1982, 1990, 2001, 2008 and even the 2020 recessions. Respect. At the moment, with the 10-year Treasury yielding 2.93% and the 2-year yielding 2.71%, it is in danger of inverting.

So, is it time to "batten down hatches" and prepare for a recession? Not so fast. These warning signs are as serious as red skies in the morning but let's visit them individually. The global economy has become far less oil intensive. The all-important U.S. consumer used to spend 7-9% of total consumption on energy in the 1970s and 1980s. This has been on a long declining trend thanks to higher incomes and efficient energy use. Currently, about 4% of consumption is spent on energy so it's not as biting as it used to be. Add in elevated savings over the past year, and perhaps the consumer is better positioned to weather higher energy prices.

Consumer sentiment data has been at odds with improving employment trends for a while now. We would also highlight it has been at odds with actual spending patterns, which have been solid. Surveys are what is called "soft economic data". Literally, people are contacted and asked what about their spending intentions. While it can provide more timely insights into the future of hard economic data such as GDP or consumer spending, it also tends to be influenced by other factors. Perhaps consumers have been in a negative mindset due to the pandemic, inflation, war, or simply too much time on social media! *Actual spending* has remained solid. Sometimes actions speak louder than words.

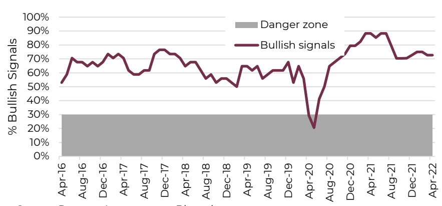
Now for the yield curve's "perfect record" of forecasting recessions. The 2s vs 10s inversion, which is the one commonly highlighted today due to its recent inversion, is less timely and less accurate than the 10s vs 3-month yields. The 2s & 10s inverted in 2005, about two years before the actual recession. Also in 1998, two and a half years early. The 2-year yields are also very influenced by the scarcity-driven inflation the world supply chains are wrestling with, creating a rather unique scenario. If you look at other countries' yield curves, the inversion signal has been much more hit and miss. Sure, we will take note if the 2s/10s invert, but will hold off sounding the R alarm given the 3-month vs 10s remains plenty steep for now. See our chart on page 1.

Yes, these signals are concerning, and we are certainly heading into a slowing economic growth world. But calling for a recession appears premature. Looking at the other side of the ledger, inventories are very low and manufacturing activities are very robust. Unemployment continues to fall. Leading indicators are still rising. Earnings growth remains positive. Many of these are equally accurate at predicting recessions. And the data today does not support the recession talk. Could the data change in the coming quarters? It most certainly will, but could change in either direction. For now, it's a slowing of growth.

Market cycle monitor

There are always many moving parts to the markets and the economy. This is why we use a broader-based market cycle approach that includes all the aforementioned indicators, plus many more. The good news is with 75% still bullish, our recession / bear market alarm bells remain quiet.

Market cycle indicators healthy



Source: Purpose Investments, Bloomberg

US Economy	Bull	Bear	10 / 11
Leading Ind (3m)	✓		-
Leading Ind (6m)	✓		+
Phili Fed Coincident	✓		+
Credit (3m)	✓		+
Recession Prob (NY Fed)	✓		+
Recession Prob (Clev Fed)	✓		+
Citi Eco Surprise	✓		-
GPD Now (Atlanta Fed)		✓	+
US Unemployment	✓		+
Consumer Sentiment (3m)		✓	+
PMI	✓		-
PMI New Orders	✓		-
Chemical Activity (3m)		✓	-
Energy Demand (YoY)	✓		-
Truck Demand (YoY)		✓	-
Rail (YoY)		✓	-
Starts (6m)	✓		+
Months Supply (6m)	✓		+
Home Sales		✓	-
New Home Sales	✓		-
NAHB Mkt Activity		✓	-

Global Economy	Bull	Bear	2 / 6
Global PMI	✓		-
Copper (6m)	✓		-
DRAM (3m)		✓	-
Oil (3m)	✓		-
Commodities (3m)	✓		-
Baltic Freight (3m)	✓		+
Kospi (3m)	✓		+
EM (3m)		✓	-

Given the heightened concern over the economy, we have shared the breakdown of which indicators are bullish and which bearish. We have also included whether the measure is improving or deteriorating. Given we use the 3-month / 10-year yield curve, this remains bullish. The U.S. economy also stacks up well with many more bullish checkmarks vs bearish. We would note the data points are roughly even split with 10 improving and 10 deteriorating vs last month. The global economy remains decent as well.

This has us in the camp: economy slowing yes, stopping no. Slowing economic growth could actually be a positive development over the coming months. It would help alleviate some of the inflationary pressures and could open the door for the market to forecast a less hawkish path for central banks, given how far the pendulum has swung in the hawkish direction of late. This is going to be a bumpy ride for the data and the markets; expect overreactions in both directions at times.

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.