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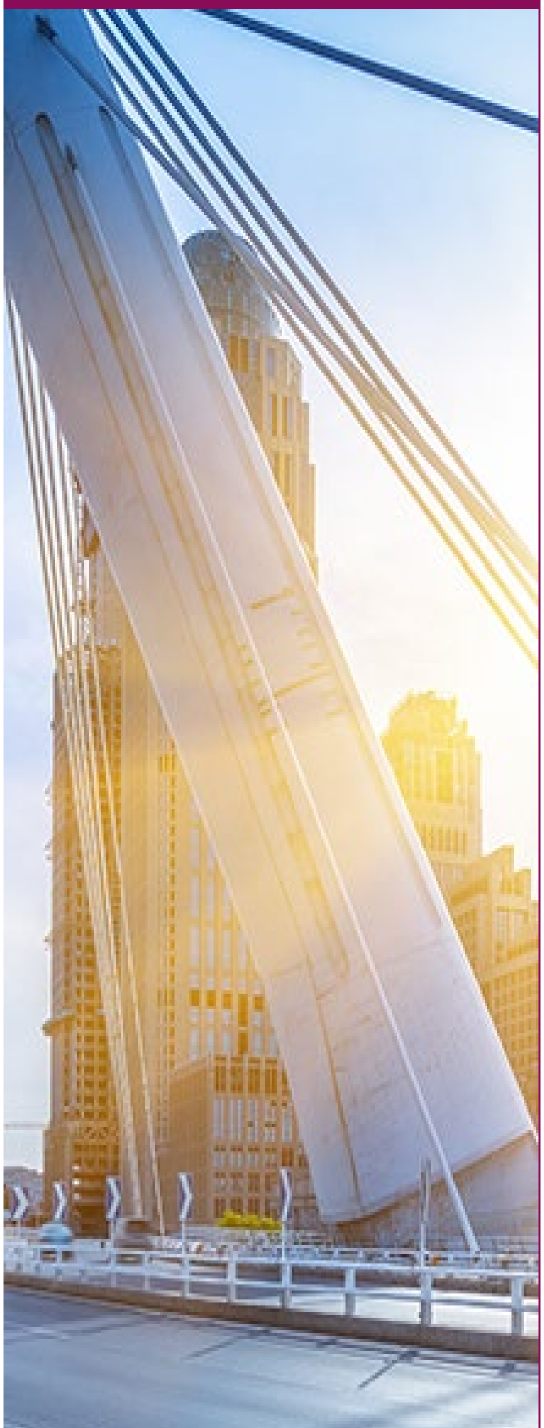
Market Ethos

The latest market insights from Richardson Wealth



Craig Basinger

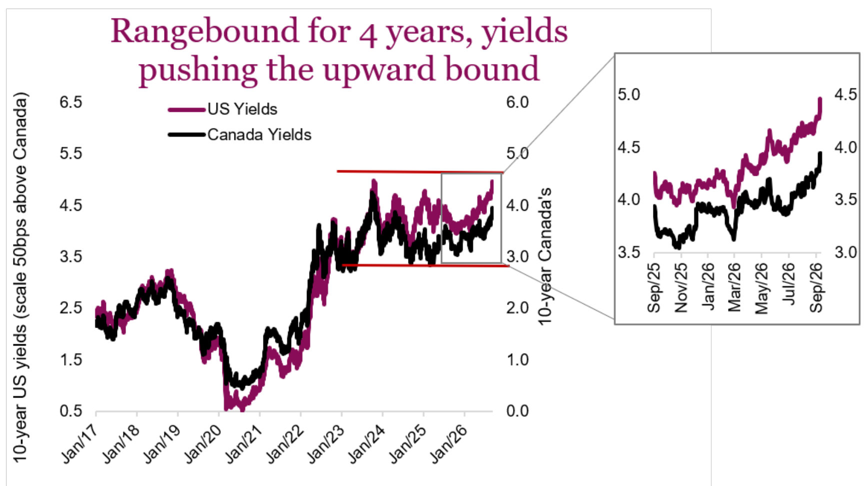
RICHARDSON Wealth

Looking beyond the yield headlines

With government debt service cost globally sitting at about $2 trillion, is this why yields are moving higher and is a government debt crisis finally upon us? Let's break this down.

Bond yields are up, with the 10-year U.S. Treasury yield nearing 5%. Canadian yields are not far behind. Taking a bit longer-term view, this has yields nearing the upper bound of the range that has persisted over the past four-plus years. There are a number of factors contributing to this rise in yields. A recent survey by Bloomberg highlights the big four reasons or concerns in order of importance to respondents:

1. Accelerating inflation,
2. Rising term premium/fiscal concerns,
3. Massive amounts of hyperscaler debt issuance and
4. Fed rate expectations.



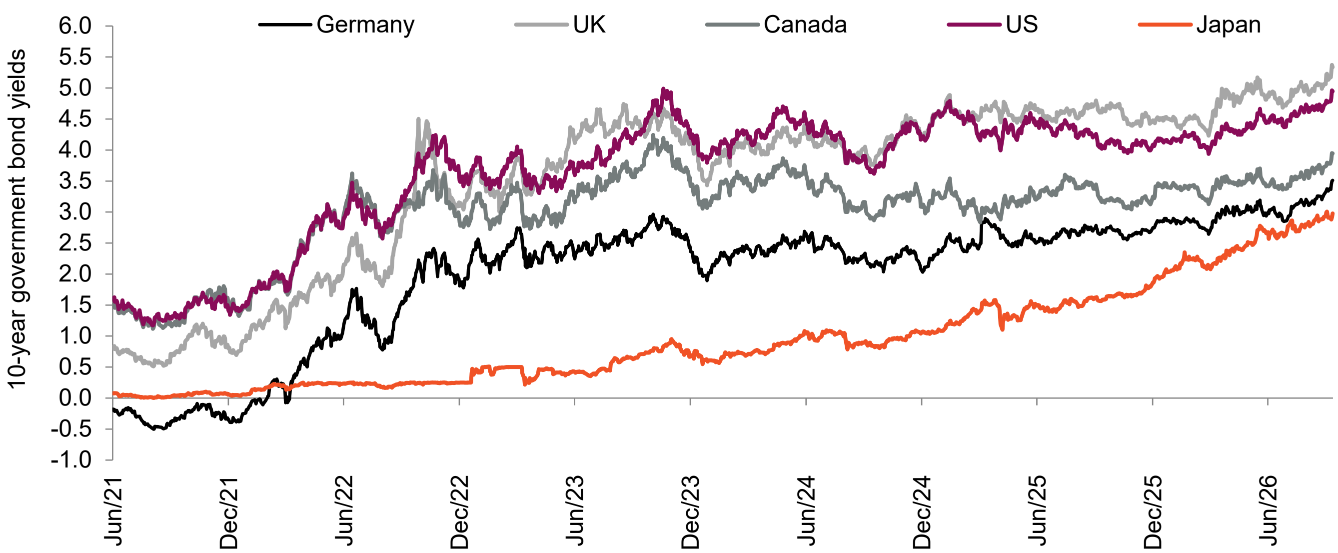
Source: Bloomberg, Purpose Investments

Let's take a look at each one by one. Inflation has not gone away, and while much lower than a few years back as the economy was emerging from the Covid-induced reverberations, it is still a persistent risk. On the positive side, wage growth has normalized, and core U.S. CPI and service inflation has slowed. On the more worrisome side of the ledger, we have diesel prices in the U.S. over $6/gal as the supply disruption from Hormuz continues to keep energy prices high. Add the gradual impact of tariffs to this. Maybe inflation accelerates as energy prices make their way through the economic machine, but for now it's too early to get excited.

Fiscal concerns is the headline grabber. No denying society has moved firmly into a spend more mindset; can't even remember the last time anyone said the word 'austerity'. The global economy is doing really well and yet governments around the world feel the need to spend more and more. The past decade of QE has given way to unrestrained fiscal spending, cemented during Covid. The solution to any problem is to spend more. Worried they might lose Congress in the midterms, the U.S. government is toying with giving everyone $5k (that would be a mere $1 trillion in total). In Canada, worried about the impact of tariffs, the solution is to ramp up fiscal spending to support industries. Not saying this is the wrong policy, (we are not policy people), but the norm in the world has become to spend at the sign of any trouble.

If bond yields are going up on fiscal spending sustainability risks, why are they going up everywhere? One could argue Canada's debt/fiscal situation is much better than our neighbours to the south, but our yields are going up too. Or look at Germany, which is in even better fiscal shape. **If this were a fiscal sustainability issue, would we not see greater divergence in the direction of bond yields based on relative fiscal health?** We will come back to this one shortly.

Global Bond Yields - up everywhere



Source: Bloomberg, Purpose Investments

The buildout of AI infrastructure is not cheap, and after hyperscalers funded much of the initial build with existing cash flow, they are now tapping debt markets more and more. The dollar amounts are pretty epic. Debt crowding out is an economic concept where issuing too much debt crowds out other issuers, who then have to offer a higher yield to attract buyers. Yes, hyperscalers are issuing an increasing amount of debt but it still pales in comparison to government issuance. And there is likely a healthy investor appetite to participate in this AI buildout. Maybe government + hyperscalers is creating some rising competition for capital, but with so much liquidity globally we don't think this is a big driver today.

The ECB just raised rates, after last week's U.S. CPI print the futures market is now pricing in a Fed rate hike on September 16 and in Japan, a BOJ hike on September 18. This is certainly contributing to higher bond yields globally, but for healthy reasons. Inflation is a bit warmer and economic growth is robust. That supports the basis for hiking rates and it also supports somewhat higher bond yields. Nominal GDP in the U.S. expanded at a 6.6% annualized pace in Q2. Higher yields and higher GDP is natural.

Another factor that has not seen much coverage is the old carry trade. The carry trade is predicated on interest rate differentials and was much more popular in years past. A big one was to borrow in Japan, with its lower rates, and invest the proceeds in higher interest rate markets such as the U.S. While not as big as it used to be, there is still a lot of capital devoted to carry trades. However, over the past month we have seen the Japanese yen rise in value aggressively as rate hike expectations rose and the government intervened. When the liability side of the carry trade (in yen) appreciates, that is not good for profitability. It likely causes some unwinding, which ends with selling of U.S. Treasuries, pushing up yields. This too has contributed to higher yields.

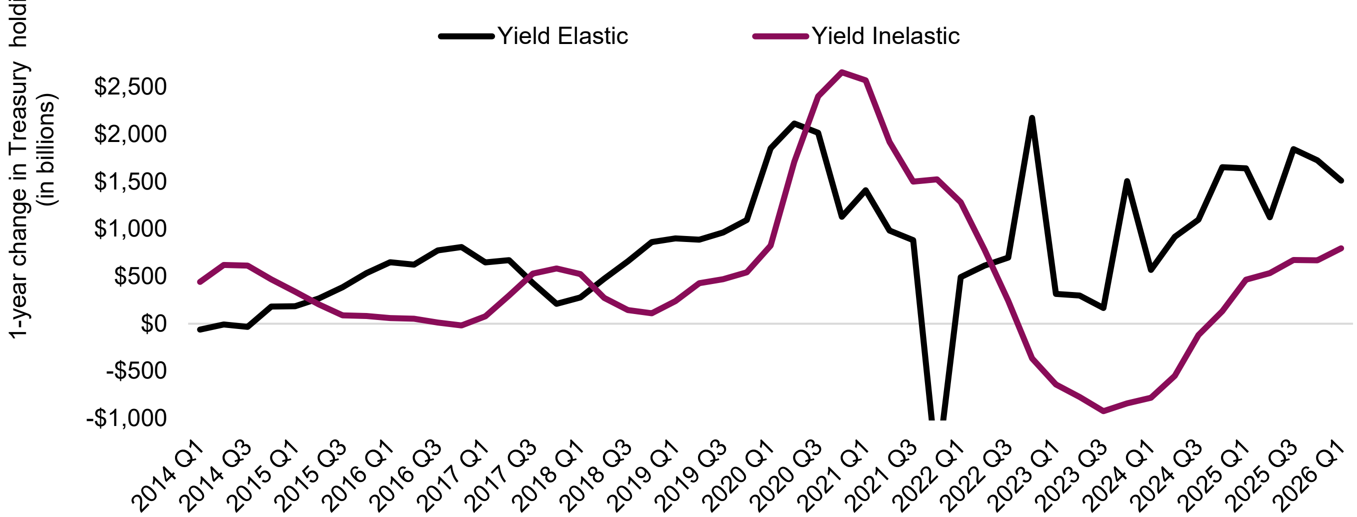
Jumping back to the fiscal sustainability topic, how we answered the question 25 years ago and how we answer it today has not materially changed. We don't doubt there is a debt crisis ahead, it is part of the debt cycle path, and it is a greater risk today than in 2001. Debt levels are much higher, even relative to a much larger economy. Demographics are also more challenging and fiscally responsible policy is sparse.

There are no reliable signals for when this could really become a problem. It isn't debt level to GDP, it isn't interest payments vs defense spending. Debt becomes an issue when you can't roll maturities or issue new debt. It is when the buyers don't show up. That is what will force policy to change, addressing deficits, or debt in some way, which won't be fun.

Our gameplan: We don't believe this debt crisis will start in Canada, nor the U.S. even with their level of debt, because of the many levers and tools a highly developed financial system has to, well, kick the can down the road. The UK did that when they had their bond dustup a few years ago. We think the debt crisis will begin in more fragile economies that don't have as many levers. That is your canary for this potential risk.

Maybe it is in 5 years, or 10 or another 25. The optimists say productivity and economic growth could save the day, but we doubt it. Governments will spend that too. The good news is these higher yields are easily clearing bond issuances. There was a 10-year and 30-year auction over the past week; yes, the yields came in on the higher side but that slightly higher yield led to an increase in the bid-to-cover ratio (aka lots of buyers).

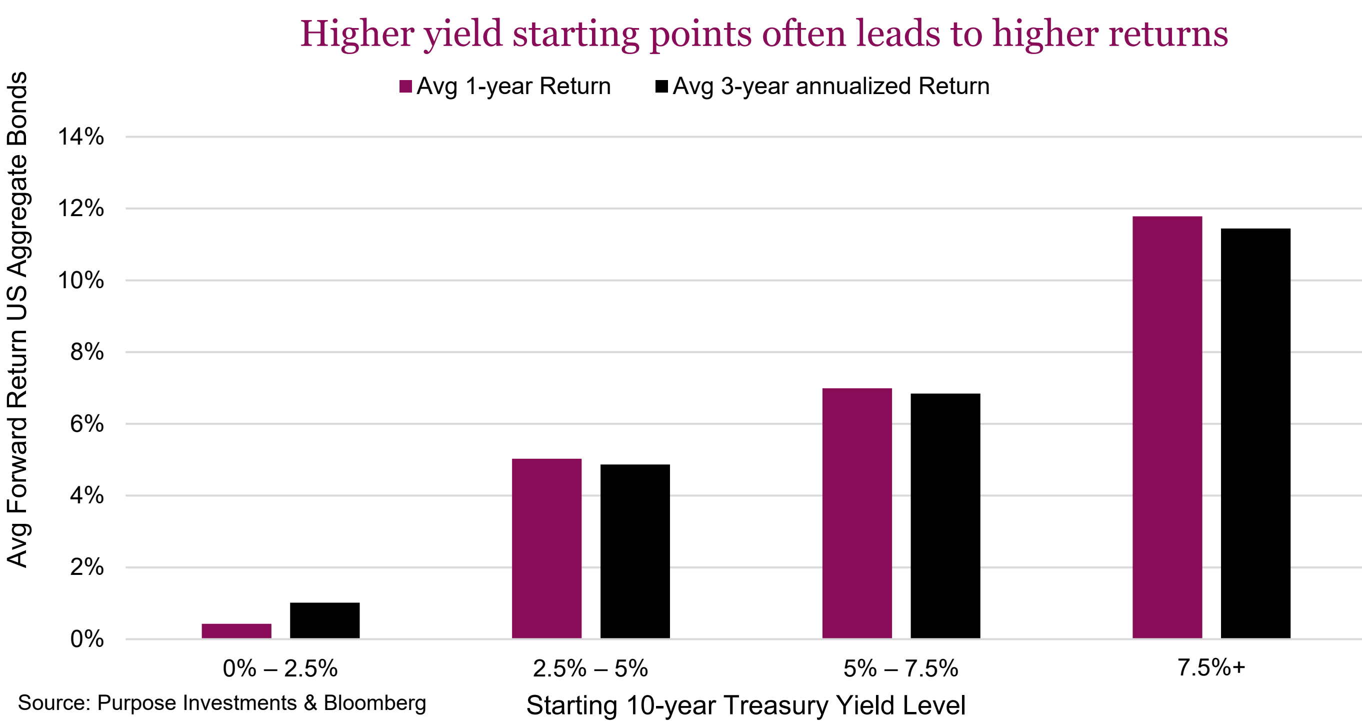
Since 2022 demand for Treasuries is driven more by Yield Elastic buyers



Source: U.S. Treasury, Bloomberg, Purpose Investments
Yield Elastic: Households, Money Market Funds, Mutual Funds/ETFs, Private Foreign capital
Yield Inelastic: Governments, Central Banks, Chartered Banks, Pensions, Insurance

Bond investors have become more yield sensitive and higher yields attract more buyers. Conversely, lower yields cause investors to go elsewhere. This is one of the factors that has kept bond yields in the same range for the past four-plus years. This may change but with yields at the upper end of the range, we are already seeing more bond buying via ETFs.

One final positive of these higher yields: it does raise the return expectation for bonds. The simple truth is that over the past 50 years, the best indicator of forward bond market returns is the yield at the starting point. Bucketing into various ranges of 10-year Treasury yields, the higher yield starting points lead to higher average forward returns over the next 1 and 3-year time periods. It might not be fun getting to the higher yield starting points, but once there, returns should be more pleasant.



Source: Purpose Investments & Bloomberg

Final thoughts

Inflation, deficits, healthy economic growth, competition for capital and hiking central banks have all combined to push yields higher. Feels good to be underweight bonds with mildly lower duration. However, with these higher yields, the attractiveness of bonds has increased. Buying bonds when the 10-year yielded 4% was bad — at 5% it is certainly less bad or even good if economic growth cools, and/or if rate hikes instill more confidence that central banks are serious about combatting inflation.

Not saying yields can't go higher, but with investing it is all about risk vs return and the ratio has improved as yields have climbed higher.

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

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*This report is authored by Craig Basinger, Chief Market Strategist at Purpose Investments Inc. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.

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