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Investor Strategy

The yields they are a-risin’

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Executive Summary

- **Part 1: Market Recap – A carbonated concoction of volatility**
  - A look back at the past month's market activity: A busy February.
- **Part 2: Asset Allocation – Yields toll for thee**
  - Rising yields have started to impact equity markets. This adjustment phase will likely continue.
- **Part 3: Equities – Reflation trade alive and well**
  - Reflationary pivot has value and cyclical yield rising relative to past growth winners.
- **Part 4: Equities – Emerging Markets**
  - Reflation and higher commodity prices are good for many emerging markets, not all though.
- **Part 5: Fixed Income – Optimistic outlook continues to push long-term yields higher**
  - Yield curve steepening into a higher gear – How far could this go?
- **Part 6: Managed Portfolios – Managing the risks in fixed income investing**
  - It's ok to be early. How we manage the bond component of Managed Portfolios during this challenging environment

Market Recap – A carbonated concoction of volatility

Chart 1: Momentum breeds momentum...

... And taper tantrums?

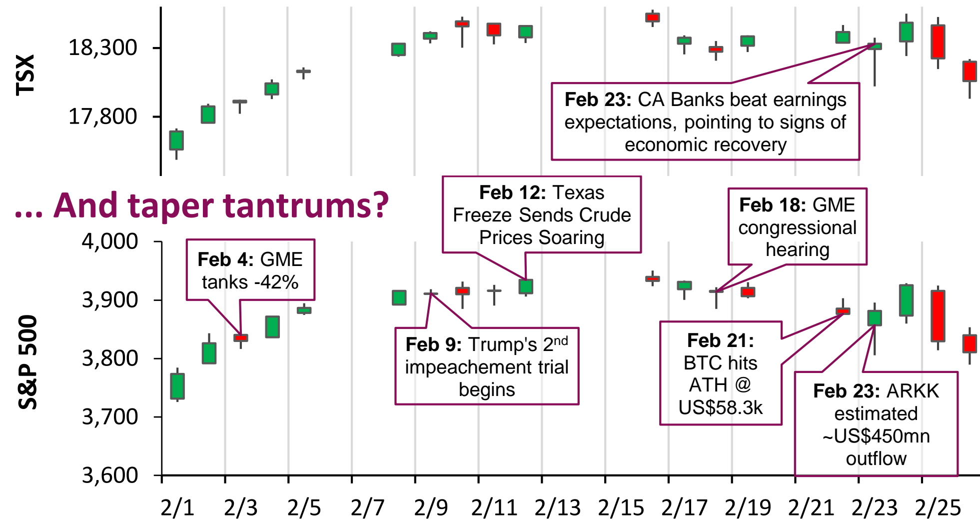
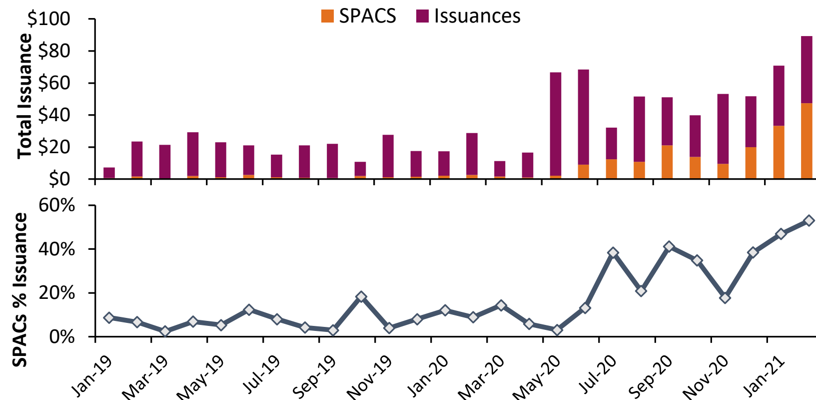


Chart 2: Heated capital markets



Alexander Tjiang

- On the back of January's volatility, February saw market participants step harder on the throttle and enable a protracted run of risk-on activity to an extent not observed in decades **(Chart 1)**.
- February's frothy backdrop was comprised mainly of **(1)** a successful continuation of COVID-19 vaccination administrations across the globe; **(2)** patient and (seemingly) stubborn signaling from the Federal Reserve and other central banks in combination with newly awoken hopes for additional fiscal stimulus; **(3)** ever-growing interest in investing from the retail community, as exhibited by Reddit's r/wallstreetbets user growth to ~9.3mn (+40% m/m); **(4)** sustained idiosyncratic pockets of speculative mispricings across a variety of assets / securities, most notably in thematic highflying equities and cryptocurrencies; and **(5)** a steady rise in global yields, followed by a last-minute inflection to pre-election highs during the month's last week.
- North American equity markets made advances higher for most of the month but retracted gains near its end as Treasury yields inflected higher at the last minute. In local currency terms, the S&P 500 posted a total return of +2.8% for the month while the TSX Composite returned +4.4% during the same period. Overseas markets, measured by EAFE in CAD terms, returned 1.5%.
- North American capital markets set a +10-year record high for monthly equity issuance activity, driven in large part by the U.S. SPAC craze **(Chart 2)**. During this month alone, 680 equity issuances were announced that in aggregate ascribed a total of ~US$94bn in new capital; of this figure, ~55% came from SPACs. The big question here is whether these recent spikes in activity are drivers for today's heated markets, or if the inverse is true. The answer likely errs towards this relationship being reflexive. At this point, it is becoming increasingly more difficult to distinguish between the horse and the carriage.
- Reflationary trades paid off, as the month was also marked by a decided increase in global bond yields, which was most notable during the last week of the month when U.S. 10-years peaked momentarily at ~1.6%. As we discuss later in this report, global economic recovery expectations have given way to steeper yield curves and pronounced outperformance in the commodities complex.
- Maneuvering through these volatile waters may appear more daunting than ever; rest assured that mental fortitude, a tempered hand, and deliberate intent will serve well in this environment. While the extremes in behaviour we are witnessing today may seem novel, history will tell us that this may be no different from the past. Human nature rarely changes; only the means and mediums through which this behaviour is cultivated and fostered are now different.

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Asset Allocation – Yields toll for thee

Craig Basinger, CFA

Chart 3: this rise in yields still has a ways to go if history is any guide

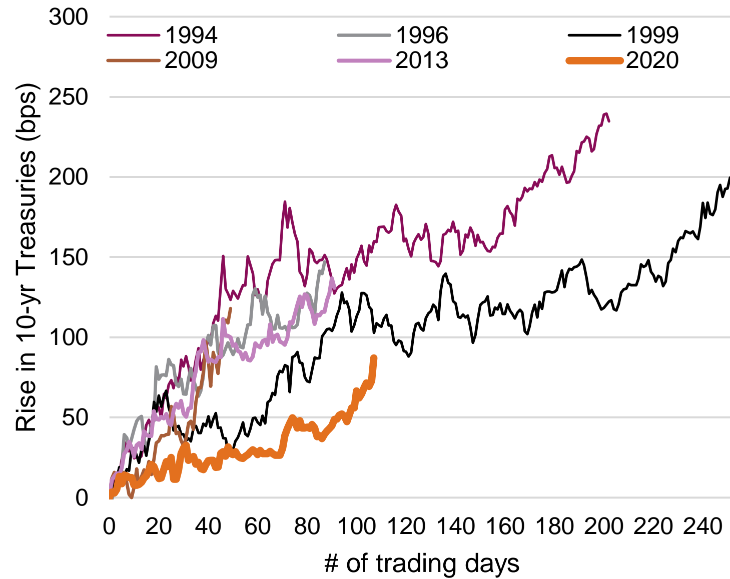
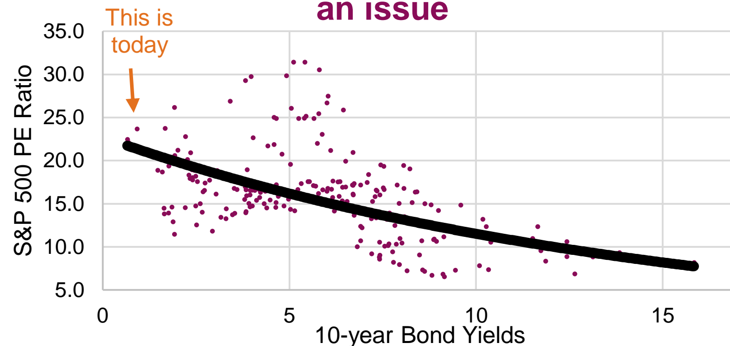


Chart 4: Lower yields and high PE ratios go together, so rising yields is an issue



- Bond yields and equity markets have a rather finicky relationship. Sometimes, falling yields are good and sometimes bad. Same with rising yields. We have opined for a few months now that the rise in bond yields, a development that started in August, is a healthy turn of events but at some point would weigh on equity markets and valuations. The markets and many asset prices have been inflated thanks to monetary policy and low bond yields. Lower bond yields are correlated with higher market valuations, so naturally rising bond yields are a headwind. But it is not that simple (it never is).
- Bond yields are rising for a very good reason: the global economic recovery continues to gain momentum on the back of vaccine rollouts putting the end of this pandemic in sight. The opening-up trade is gaining and few would argue this is a very welcome development. However, there is a pain point should yields rise too far or too fast. The equity markets experienced a taste of this in late February. The 10-year U.S. Treasury yield, which had been steadily rising, jumped over 14 basis points (bps) in one day sending equity markets into a bit of a tizzy.
- We continue to believe that bond yields will move higher in the coming months and this will continue to weigh on equity prices, especially the more interest rate-sensitive sectors and the longer-duration growth companies (aka large-cap tech). This adjustment process to higher yields is well underway in some sectors (gold, consumer staples) and still in the early phases for many growth names.
- This could very easily push the market into a correction (10% drop or more). The industries and companies at great risk to higher yields simply carry a heavy weight in the indices of both the U.S. and Canada, although to a lesser extent. While the companies that benefit from higher yields, like financials and cyclical yield names (*Read Market Ethos on Cycle Yield* HERE), have a smaller representation in the indices.
- Looking at previous bouts of rising bond yields, it is difficult to draw hard conclusions (**Chart 3**). The fact is, each occurred for different reasons, in different environments and from different starting points: 1994 was over government deficits and 1999 due to an overheating economy. Perhaps the most similar to the current situation is 2009, when yields rose coming out of a recession. During the 2009 episode of rising yields, equity markets did alright, better in the early days and worse as yields got higher. We would expect a similar pattern during the current environment, if yields get too high or rise too fast, equity markets will suffer.
- Yields could keep rising for some time. This is not just because of the low starting point, but inflationary data is starting to surface. And, any year-over-year economic data metrics released in the coming months is going to be exaggerated because the comparable from a year ago will be in the depths of the pandemic-driven shutdowns.
- The good news is that this adjustment phase to potentially higher yields is a healthy event. It may create a correction due to valuations re-adjusting (**Chart 4),** which should be viewed as a buying opportunity. The fact is that the economic situation is getting better, the world is getting better and longer term this will be good for earnings and the markets.

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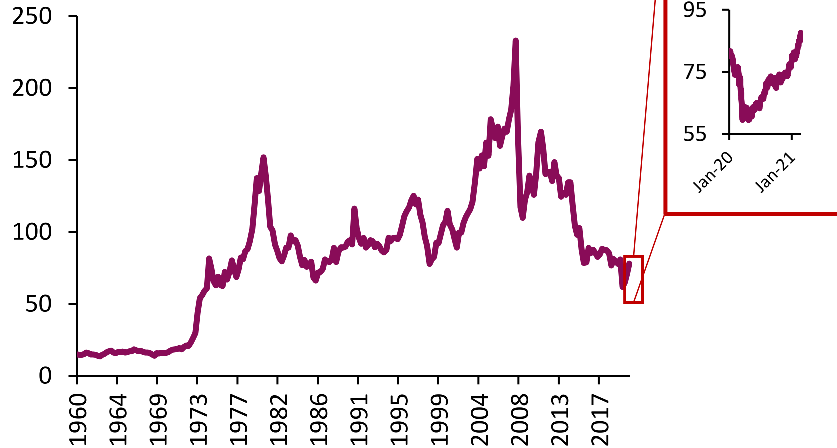
Equities – Reflation trade alive and well

Derek Benedet, CMT



- The jump in government bond yields confirms the reflationary move in the markets that we've been expecting. Compared to prior bond sell-offs, this period of rising bond yields has the short end of the curve locked steady while the long end has risen due to growing expectations of an economic recovery. The trend in yields has been evident since the summer, so why is the market only beginning to care now? The recent spike in the Move Index – which is a Treasury volatility measure – distinguishes the recent move compared to the far more attritional up move in bond yields last year. We should also note that it's not just the U.S., or the Fed, or President Biden's $1.9 billion stimulus plan; rather, it has been a global move. From Japan to Germany, yield curves have been steepening.
- It's not just the bond market that is demonstrating that the reflation trade is alive and well. Commodities too are screaming the same message. Oil prices have risen substantially, same with copper, lumber and food and the list goes on. **Chart 5** shows the Bloomberg Commodity Index and if you just look at the past year, it would be easy to think that commodity prices have gotten a little out of control, however when you zoom out and observe longer term, commodities are barely at the foothills of what could be another super cycle. So far, the current outperformance of commodity markets is nothing like the 1970s or the early 2000s. One area of concern over the near term would be how stretched managed-money speculative positions are across the commodity space. Demand expectations are there, but so far, there has been a lot of speculative money driving prices higher.
- While a lot of attention has been paid to the likes of GameStop and other isolated asset mispricings, the reflationary trade has been driving a growing sector disparity in equity markets. The clear winners are Energy, Materials, and Financials as **Chart 6** clearly illustrates in both Canada and the U.S. It's also the reason why Canada has been outperforming U.S. markets year to date as the TSX's combined weight of these sectors is ~55.3% versus ~16.7% for the S&P 500. Interest-rate sensitive sectors have had a tough time, with Utilities and Telecom names struggling.
- Markets do trend – *momentum investors have built careers off this* – but they also reverse, and when momentum reverses it can happen quickly. Tech tried its best to reverse course and play catch up but is having a difficult time coping with higher bond yields. As we noted in a recent Market Ethos, many of the cheaper value areas are inflecting materially higher and we expect to see a pullback in expensive growth areas. The reflation trade means that big tech and recent MOMO (or momentum) winners have lost their MOJO. The value versus growth rotation still has room to run.
- Markets are doing what they are supposed to do: discount events before they happen. With bankers eager to provoke inflation, and "go big" the common mantra for fiscal spending plans, we believe that the reflationary trade – while potentially overheated in the near-term – has staying power. Inflation has yet to rear its ugly head in the data, but the fear of inflation is what moves markets, not just a monthly data release.

Chart 6: Sector total return breakdown

	TSX		S&P 500	
	1m	3m	1m	3m
Energy	8%	12%	22%	32%
Materials	-5%	-6%	4%	4%
Industrial	4%	4%	7%	4%
Con. Disc.	6%	10%	-1%	2%
Staples	-1%	-6%	-1%	-4%
Healthcare	3%	25%	-2%	4%
Financials	7%	9%	12%	17%
Real Estate	4%	3%	3%	5%
Technology	7%	9%	2%	7%
Telecom	-1%	-1%	7%	9%
Utilities	-5%	-2%	-4%	-4%

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Equities - Emerging Markets

Chris Kerlow, CFA

Chart 7: as go commodities, so goes emerging markets

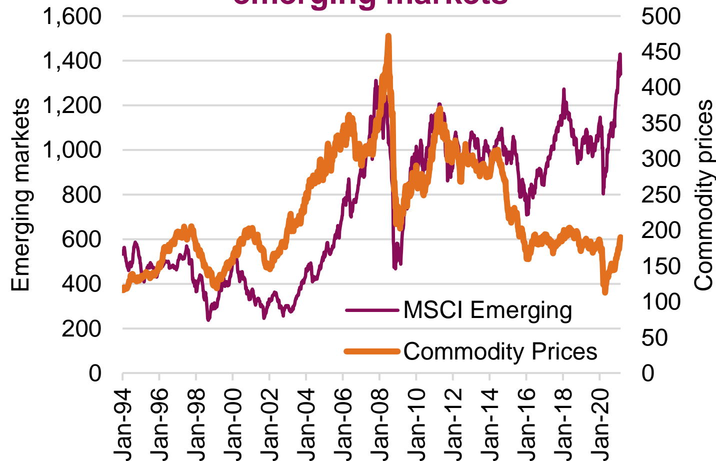
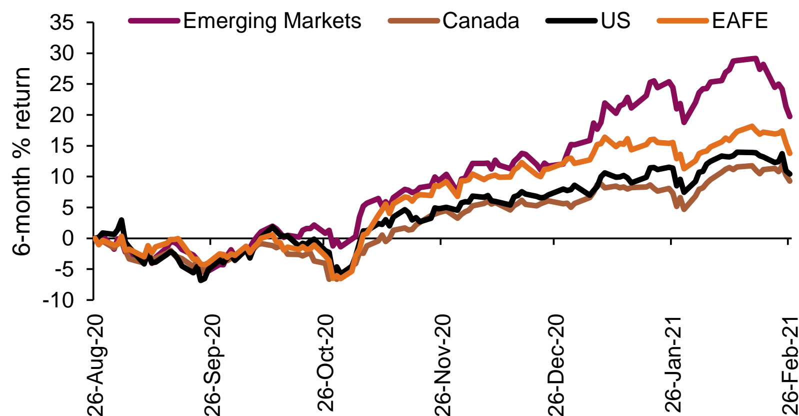


Chart 8: Performance



- In September 2020, we added exposure to Emerging Markets (EM), then added again at the start of this year. We were expecting to see a rotation out of U.S. stocks into non-U.S. names while also under the notion that EM tends to outperform at the start of an expansion and reflationary environment.
- The trend started in the summer and has continued as economies around the world slowly recover from the pandemic. Semiconductor and commodity prices have also added to the outperformance.
- A restocking of semiconductor inventory has aided EM, in particular South Korea and Taiwan, but much of these growth expectations are likely already priced in. There is still a shortage, but it is waning.
- The Materials sector, on the back of stronger commodity prices, is the other area of optimism for EM because of the strong correlation between the two. Absolute forward earnings growth is expected to be in the mid ~20% range over the next 12 months. Industrial metal prices have also been on a tear, but historically are quite volatile and tend to be mean reverting.
- Much of the gain in industrial metal prices comes off the back of the early recovery in China's economy. Demand for base metals could be sustained as the rest of the world continues to recover.
- China dominates the EM index, accounting for 38%. Chinese returns tend to do well when house-price increases are muted and access to leverage is readily available, as is the case now.
- With China, Korea and Taiwan accounting for almost two thirds of the EM index, they have driven index returns as of late. The Asian market outperformance is likely going to need to continue for the trade to keep working.
- Like the mega-cap concentration in the S&P 500, 22% of the EM benchmark is made up of just four technology stocks.
- When we look at EM, we look at EM ex-China as well. Ex-China EM offers a more cyclically oriented global exposure versus a domestic Chinese earnings exposure trade. Ex-China EM accounts for one-fifth of the world's energy and resource stocks.
- As a result of our analysis and based on the confluence of reasons above, we are sanguine about EM and remain slightly overweight. We are not adding at this point because the easy money appears to be baked into prices. However, the space should benefit from the reflation trade and should fare better than other regions in a rising rate environment.

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Fixed Income – Optimistic outlook continues to push long-term yields higher

Chart 9: US Treasury yield curve, what a difference from a year ago

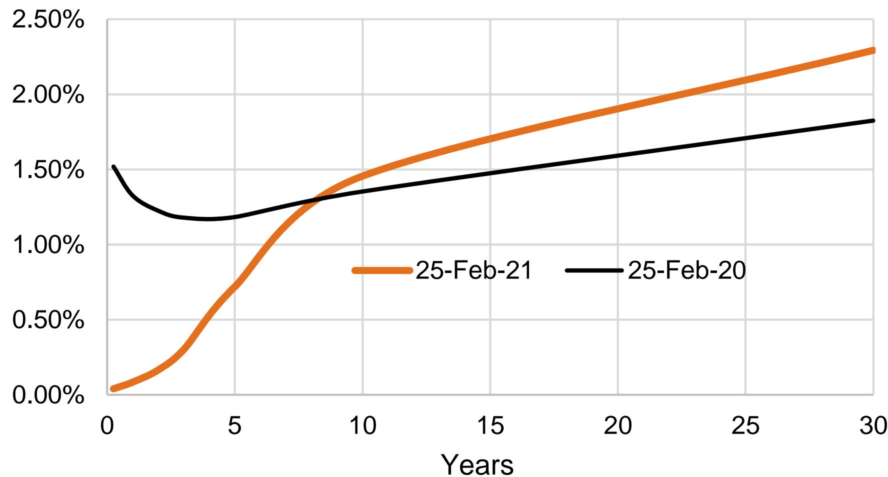
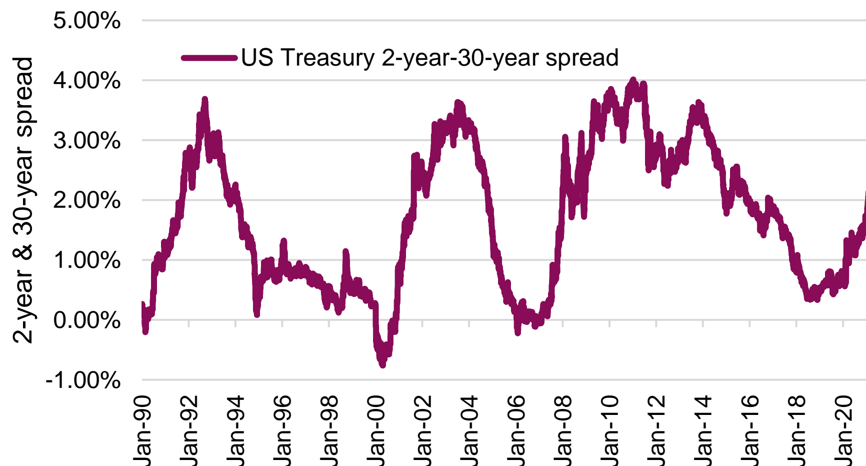


Chart 10: Yield curve steepening has begun



Joey Mack, CFA

- Optimism over the economic growth outlook has become the defining theme for bond markets.
- With expectations for a sharp rebound in activity this year, yields have continued to move higher, with longer-term yields now higher than where they were prior to the pandemic.
- Shorter-term yields however remained anchored by central bank policy rates. In February, policy makers reiterated their intention to keep short-term rates low and to continue with monetary stimulus measures until growth is fully entrenched and until inflation, which has been stubbornly low for many years, finally pushes above 2.0%.
- Although much of the move has been driven by expectations of higher inflation going forward, we have also seen a move in real yields. Indeed, the yield on long-term U.S. Treasury Inflation Protected Securities (TIPS) and Canadian Government Real Return Bonds (RRBs) moved into positive territory in February, marking the first time in over a year.
- This has translated into a much steeper yield curve. The yield pick-up on 30-year Treasuries over 2-year Treasuries is at 2.14% at the time of writing, versus 0.60% a year ago **(Chart 9).**
- Historically, the steepening of the yield curve during periods of economic expansion often peaks when the spread between 30-year Treasuries and 2-year Treasuries reaches the area of 3.50% **(Chart 10).**
- This suggests we may see further weakness in longer-term bond yields in the coming months. Long bond yields could reach as high as 3.75% before central banks around the world reach their growth, employment, and inflation goals and then start to signal a willingness to raise short-term rates.
- Historically, higher government bond yields generally lead to wider credit spreads; similarly, higher yields will often lead to weakness in risky assets given the rising attractiveness of safe assets. However, we continue to see strong demand for yield in what remains a historically low-yield environment, and the yield ratio (the percentage of credit spread of total yield) remains attractive. This should help credit markets continue to outperform in the near term.

Managed Portfolios – Managing the risks in fixed income investing

An Nguyen, CFA

Chart 11: Steepening yield curve in U.S. Treasuries

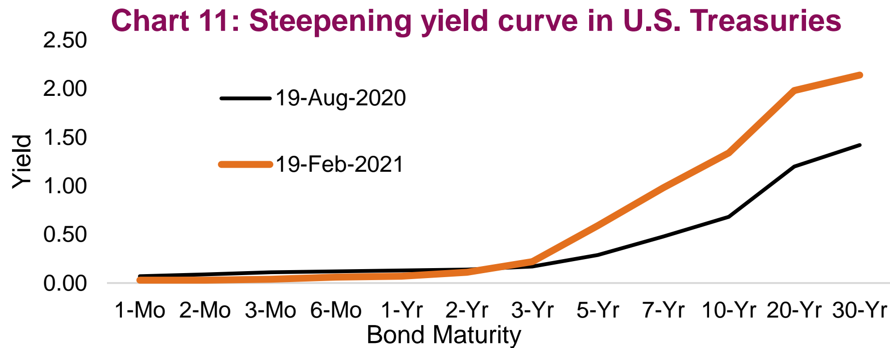


Chart 12: Bond Returns and Risk/Reward

	2020	2019	2018	2017	2016	5-Yr* Std dev	5-Yr* Rtn
Cdn Short Term Bonds	5.2	3.0	1.8	-0.1	0.8	1.4	2.1
Cdn Universe Bond	8.6	6.8	1.3	2.3	1.4	4.1	3.7
High Yield Bonds (US$)	4.7	15.0	-3.2	6.5	14.8	7.6	7.8
Inflation Protected Bonds (US$)	11.5	8.6	-1.6	3.1	4.7	3.8	4.9
Intl Treasury Bonds (US$)	9.7	5.6	-2.3	10.1	1.0	6.8	4.3
Investment Gr Corp Bonds (US$)	11.1	17.1	-3.8	7.2	6.0	6.6	7.0
Long Treasury Bonds (US$)	17.9	14.9	-2.1	8.9	1.4	11.8	6.0

*Passive ETFs that invest in broad market bond indices were used to calculate the bond returns. The returns are shown net of the ETF fees. 5-year standard deviation and returns are as of 01/31/2021.

Chart 13: Managed Portfolio Fixed Income Holdings

Bond	Rate Sensitivity	Credit Risk	Geography
BMO Aggregate Bond ETF	High	Low	Canada
Dynamic Pref Yield Class Series F	Low	High	Canada-focused
iShares Core Cdn Short Term Bd ETF	Low	Low	Canada
Lysander-Canso Corp Value Bond F	Moderate	High	North American
Manulife Strategic Income F	Moderate	High	Global
Picton Mahoney Fortifed Inc CL F	Low	High	Global
PIMCO Global Short Maturity Sr F	Low	Moderate	Global
SPDR ® Portfolio TIPS ETF	High	Low	U.S.
Cash	Low	Low	N/A

- **Managed Portfolios** is the portfolio implementation tool for our investment ideas and outlook. It captures our recommended asset mix and style tilts, geographic and bond allocations all in one portfolio. In a recent *Investor Strategy*, we discussed some of the heightened risks with fixed income investing including interest rate and credit risks to name a few. None of these risks are new, but over the last year and at different times, these risks have either been magnified or have grown. In this month's edition, we delve deeper into how we have navigated some of the headwinds facing the asset class, and more importantly how we will continue to approach these challenges ahead.

- **Interest rate risk.** After spending most of 2020 well below 1%, the 10-year U.S. Treasury bond yield climbed to its highest level in a year. A comparison of the yield curve at the time of writing versus six-months ago shows a clear steepening (**Chart 11**). For many investors, bonds act as the ballast to their portfolios. They are expected to lower portfolio volatility and provide some level of principal protection. Rising rates would put into question these tenets as bonds, particularly longer-dated bonds, can experience significant volatility and negative annual returns (**Chart 12**). We have been cautious with the portfolio's interest-rate exposure for some time and reduced the portfolio's duration well in advance of this year's latest climb (we admittedly did this very early). Since rising rates negatively impact bond prices, it was the tradeoff we were willing to make to try to insulate the portfolio from what seemed like an inevitable outcome.

- **Credit risk.** We were underweight credit heading into the pandemic-induced recession last year. In April 2020, after credit spreads widened to levels not seen since the global financial crises, we introduced a credit specialty manager. Furthermore, in January of this year we added a long/short credit fund to help hedge some of the credit risk. Due to the variability in bond returns (**Chart 12**), the credit funds in the portfolio were selected in part due to its flexible mandates. This flexibility gives each manager the room to allocate across sectors and the credit spectrum, thereby allowing them to reduce the portfolio's risk at their discretion.

- **Other risks.** Inflation and liquidity risks receive less attention yet can be stealthily damaging, once the risks materialize. We introduced Treasury Inflation Protected Securities (TIPS) to the portfolio last year. The TIPS were bought at a relatively attractive price as inflation was muted at the time. Liquidity pains happen infrequently, but when they do, they are pronounced. This was the case during the height of the market correction in March 2020 when bond markets seized up and government programs were introduced to provide support. To help minimize liquidity issues, we invest in daily liquid funds that cannot gate (that is, limit) their redemptions.

- As we cannot predict the timing or duration of the risks discussed above, the bonds held in *Managed Portfolios* are diversified across maturities, sectors, and geographies. **Chart 13** highlights how the funds in the portfolio vary by geography and how each fund could potentially react to risks such as interest rate and credit risks. While this list may change, our objective to manage the risk-return tradeoff of the bond portion of the *Managed Portfolios* remains the same.

Disclaimer

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

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