MAY 2020

Bond to Basics

Why fixed income has been and continues to be important in investor portfolios

— By the Active and Strategic Fixed Income team, Jean-Guy Mérette, Vice President and Portfolio Manager

Following a stellar performance in 2019 with Canadian universe bonds returning almost 7%, at the beginning of the year we were hearing some legitimate concerns that bonds might have lost their appeal — after all, yields were at historic lows, credit spreads were tight, and the North American economy was showing no signs of slowing down. Then COVID-19 happened and the bond market turned out to be one of the only asset classes to end the first quarter of 2020 in positive territory, mitigating double-digit equity losses in most balanced portfolios. Yet even in the wake of the significant drop in yields, we believe that an active Canadian universe bond strategy should still not be overlooked. Bonds have been a core holding for investor portfolios for over a century for good reason, and as an asset class, they should not be disregarded in the current market context.

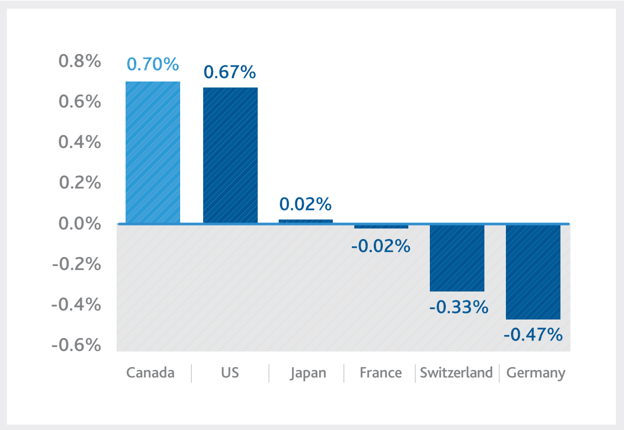
Below, we remind investors of the three main reasons bonds have been so important to Canadian portfolios historically, and why those reasons continue to hold true.

1

Income Stability

With yields across the world consistently decreasing over the past decades, fixed income participants have gotten used to regularly receiving substantial capital gains, overshadowing the other part of the trade — a reliable source of income. Nonetheless, providing a predictable and stable income is one of bonds' main benefits, and it can make the crucial difference between being able to meet current obligations and having to sell assets at the wrong time.

Global 10-year government bond yields



Source: Bloomberg as of March 31, 2020.

It's no secret that bond yields the world over are lower than ever before. That said, Canada is one of the highest-yielding developed countries right now, and the yield-to-maturity of the Canadian universe bond index in fact increased in March 2020 — a month during which the COVID-19 crisis reached its peak and the Canadian 10-year yield fell more than 40 basis points. Federal bonds only represent 30% of the universe, and while those bonds' yields were tumbling, provincial and corporate yields were rising, providing active managers with excellent trading opportunities. Additionally, an active strategy can obtain a higher yield-to-maturity than the index (i.e. carry) for the same amount of risk by diligently selecting securities that offer the best risk/reward.

In a traditional portfolio, the other option to earn income is from dividends. Indeed, equity dividends can play an important part in providing cash flows for investors, but keep in mind that they aren't as reliable as bond payments are, particularly in difficult economic times. Corporations tend to decrease or suspend dividends during recessions to preserve balance sheet strength; for instance, the S&P 500's total dividend payouts declined by almost 25% during the Global Financial Crisis. In today's environment, we're already starting to see some companies bend under the weight of the global recession that's almost certainly upon us. Blue-chip companies such as Ford, Delta Airlines and Macy's have already said they will suspend their dividend for Q2 2020 while the Bank of England pressured UK's largest banks to not pay out dividends in 2020. To be clear, dividends provide an essential part of the returns of investor portfolios and shouldn't be disregarded, but we urge investors with short memories (who may not remember what a recession is like) to remember that replacing interest income with dividends means a significant step up the risk ladder, and corporations will have difficult decisions to make regarding capital allocation during what should be one of the worst recessions in history. For this reason, keep bonds top of mind when seeking safe income.

2

Diversification

During an economic downturn, fears take over and equity markets usually suffer the most while bonds benefit from monetary policy easing and a general flight to safety, which send yields lower, generating capital gains. On a multitude of occasions, bonds have proven their value in decreasing equity markets, and many investors are even paying for the right to hold bonds and their diversification benefit, with trillions of negative-yielding new issues having found takers globally.

Total return during the worst quarters of the 21st century

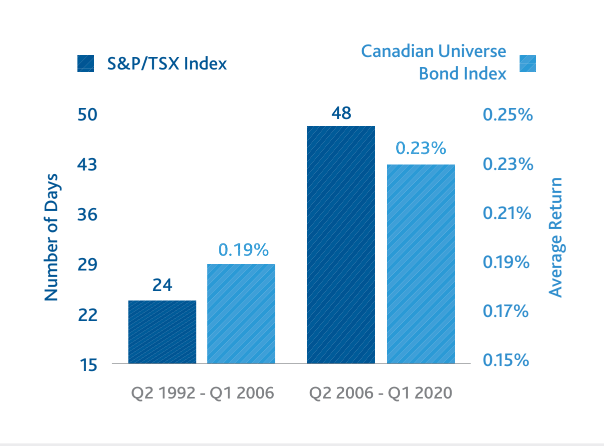
	S&P TSX Index	S&P 500 Index	Canadian Universe Bond Index
Q1 2020	-20.90%	-19.60%	1.56%
Q4 2018	-10.11%	-13.52%	1.76%
Q3 2011	-12.02%	-13.87%	5.12%
Q2 2010	-6.17%	-11.86%	2.93%
Q1 2009	-2.97%	-11.67%	4.50%
Q4 2008	-21.71%	-21.94%	4.50%
Q3 2008	-18.76%	-8.88%	-0.37%
Q3 2002	-13.51%	-17.63%	4.23%
Q2 2002	-8.99%	-13.73%	3.09%
Q3 2001	-11.60%	-14.99%	4.75%
Q1 2001	-14.84%	-12.11%	1.76%

Source: Bloomberg and PC Bond.

Admittedly, central banks' benchmark rates are at historical lows, so one could be forgiven for thinking that there's no more room for capital gains. But we would disagree. With negative rates no longer being an unconventional monetary policy tool – policy rates of the European Central Bank (-0.50%) and the Bank of Japan (-0.1%) come to mind – and with the Bank of Canada and the Federal Reserve just one cut away from negative rates, seeing rates dip even lower in North America is a real possibility.

Moreover, equity markets move faster than ever before, as a more globalized economy entails more aggressive market responses to material news from anywhere in the world. In the 14 years ending March 31st, 2020, the S&P/TSX registered 48 days during which the index lost 3% or more, twice the number of the previous 14 years[1]. Luckily, bond markets also react more quickly to market events — the Canadian universe bond index posted greater returns on days of the past 14 years' large equity drawdowns than on the ones over the previous 14 years, providing important downside protection when investors need it the most and allowing for smoother returns over time. Thus, with volatility almost certainly to remain elevated in the near future as the pandemic continues to drive financial markets, bonds' ability to diversify a portfolio has increased greatly.

S&P/TSX daily decreases of 3% or more and the average performance of the Canadian universe bonds on these days



Source: Bloomberg and PC Bond, as of March 31, 2020.

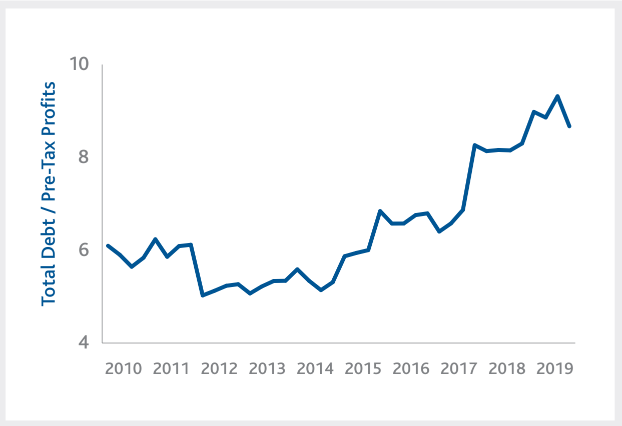
1 The Canadian Universe Bond index began issuing daily returns in 1992, hence we began our analysis then.

3

Capital Protection

We don't feel we need to discuss the safety of Canadian government bonds — they have never defaulted, and despite all the fiscal measures unleashed lately, we continue to believe in their ability to provide extremely safe payments. Governments will certainly have to deal with large budget deficits in the future because of the pandemic, but we believe that the financial aid was well-targeted to help consumers and smaller businesses weather the storm and that the situation will remain disciplined and under control.

U.S. non-financial corporate sector gross leverage

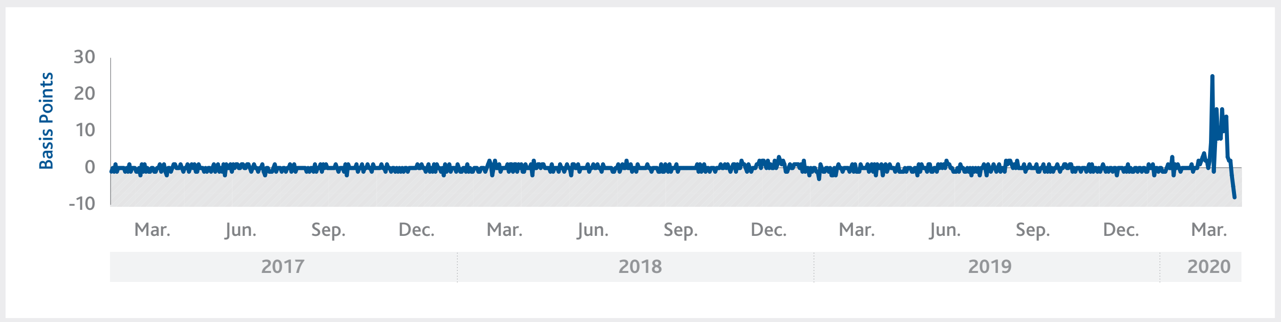


Source: FRED, data from January 2010 to October 2019.

Corporate bonds, however, are a different story. Ratings agency S&P said default rates in the U.S. may rise over 10%, a figure that wouldn't surprise us as the lower yield environment over the last years has incited companies to increase their leverage, weakening their balance sheets. Does that mean we should avoid the corporate space altogether? Clearly, we wouldn't recommend buying every corporate issue in the index; some companies are stronger than others, and there will almost certainly be defaults or at least downgrades in major Canadian companies. Still, corporate bonds — with an average yield-to-maturity of 3.2% — remain an excellent way to increase portfolio yield. With thorough credit analysis, bond participants can in fact be well-compensated on a risk/reward basis for investing in high-quality issuers with strong balance sheets and sustainable cash flows that will likely help them service their debt and survive through the crisis.

Moreover, the market is already pricing-in a severe recession, with corporate spreads at their widest since the Global Financial Crisis. As Warren Buffet once said, "be greedy when others are fearful". All the uncertainty regarding the COVID-19 outbreak and the potential economic recovery brought back significant volatility in corporate spreads for the first time in years, allowing astute portfolio managers to trade on opportune days and take advantage of panic selling. But again, in-depth analysis and an active approach are required to identify key economic trends and swiftly and strategically adjust the portfolio's corporate exposure to profit from the rapidly-evolving situation while avoiding pitfalls that passive managers don't.

Daily corporate spread change



Source: Bloomberg, as of March 31, 2020.

Bottom Line

Keep in Mind the Basics

Canadian bonds have been contributing to investor portfolios for over a century, delivering exactly what one would have expected: a reliable income, great diversification during down equity markets, and important capital protection. The COVID-19 pandemic has indeed brought heightened uncertainty in financial markets, and an active Canadian bond manager, with the ability to find and seize market opportunities, still has the means to help investors navigate through these unprecedented times. Don't let low yields be the sole factor in your investment decisions. Remember the basics of bonds' benefits in your portfolio.

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