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STRATEGIES FOR SUCCESSFUL INVESTING

MARKET STRATEGY

Rates are going up. Be afraid? Very afraid?

BONDS & BEARS

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OKAY. AFTER DROPPING RATES TO zero per cent in December 2008 and holding them there for over six years, the U.S. Federal Reserve ("the Fed") wants to now hike rates. Should we be afraid? We'd argue, "No!" Sure, the bond market could easily over-react and we could have another bear market—making it the second one in a couple of years—but let's think longer-term.

When the Fed begins to hike its administered rate ("the fed funds rate"), investors will begin to price in further hikes and eventually look for the end game. With the wonderful tool more commonly known as the "Dot Plots," we already have an idea of what that end game is. Or do we?

WHAT'S A 'DOT PLOT?'

The Fed's dot plots represent each Federal Reserve governor's forecast of where the fed funds rate will be at the end of each year for the next few years and longer term. We've heard several governors suggest that, over the long-run, they expect the fed funds rate to move to roughly four per cent, thereby paying a real rate of about two per cent given the long-run inflation target.

We'd argue that the fed funds rate will settle in at a lower level when the Fed is at the end game of its tightening cycle. Let's remember: the fed funds rate is the rate that depository institutions lend to each other overnight. It's also a good proxy for the U.S. 91-day Treasury bill rate (see chart at top of page 2).

'RISK-FREE RATE' IS KEY

And what else is the U.S. 91-day Treasury bill called? It's the "risk-free rate." That's important, because it anchors all other interest rates. The question to ask is not, "When is the Fed going to hike rates and how fast?", but rather, "What should investors expect to earn when they lend the government money for three months?" We argue that the Fed should only be paying investors for inflation; investors shouldn't be getting a real rate of interest (i.e., something above the inflation rate) on an instrument considered risk-free.

This means the Fed will only have to raise rates to the 2.0 per cent to 2.5 per cent area in the current cycle, as long as inflation remains contained. The Bank of Canada and the Bank of England may agree. Those institutions are studying normalization of interest rates in the cycle, with the expectation that rates will not rise to historical levels. Our research supports this view, given the higher level of leverage being used in the economy compared to the past.

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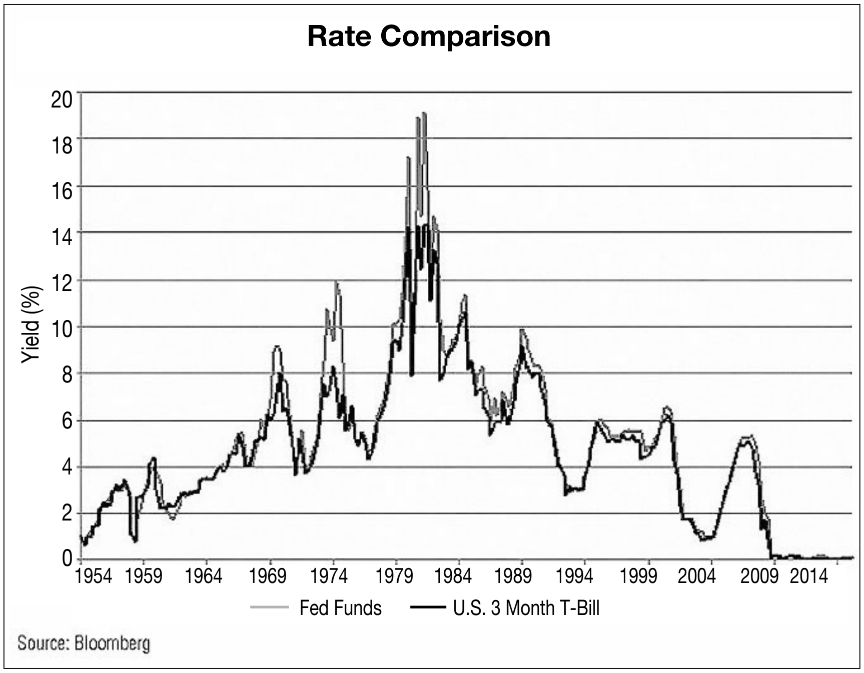


ANCHOR FOR LONG-TERM RATES

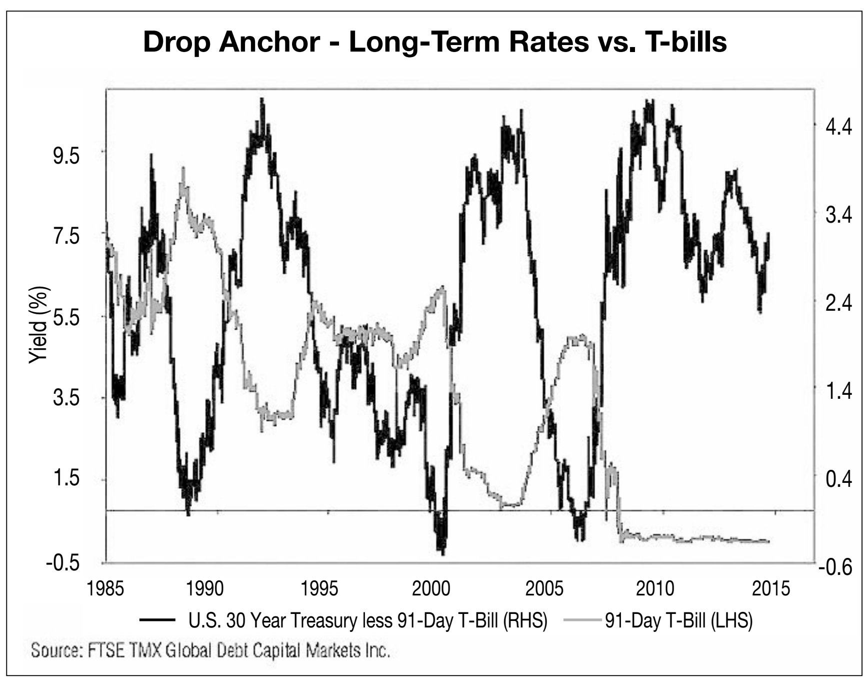
Like a boat tethered to its anchor, longer-term interest rates, or bond yields, are tethered to the fed funds rate. See how the difference between the 30-year Treasury bond yield and the 91-day T-bill yield has behaved over the past 30-plus years (the black line on the chart at the bottom of this page). Like a tethered boat, the 30-year yield has drifted only so far away from its anchor. In the past, that's meant that 30-year yields have peaked at roughly 4.5 per cent above the fed funds rate. So you might conclude that means bond yields should increase to seven per cent if the fed funds rate goes to 2.5 per cent. As the Brits are fond of saying, "Not bloody likely."

Why? We need to look at what happens to bond yields when the Fed raises rates. Have a close look at that chart at the bottom of page 2. Notice that the peak in the black line occurs when the grey line has bottomed. That grey line is the 91-day T-bill yield. When it is going up (concurrent with fed funds rate hikes), the black line has fallen. The trough in the black line occurs at the peak of the grey line. So if history is a guide, the black line should fall as the Fed raises rates from zero per cent towards that 2.0 per cent to 2.5 per cent level. We think the black line will move to roughly the 1.5 per cent area or lower. This means the peak in 30-year yields should remain below five per cent.

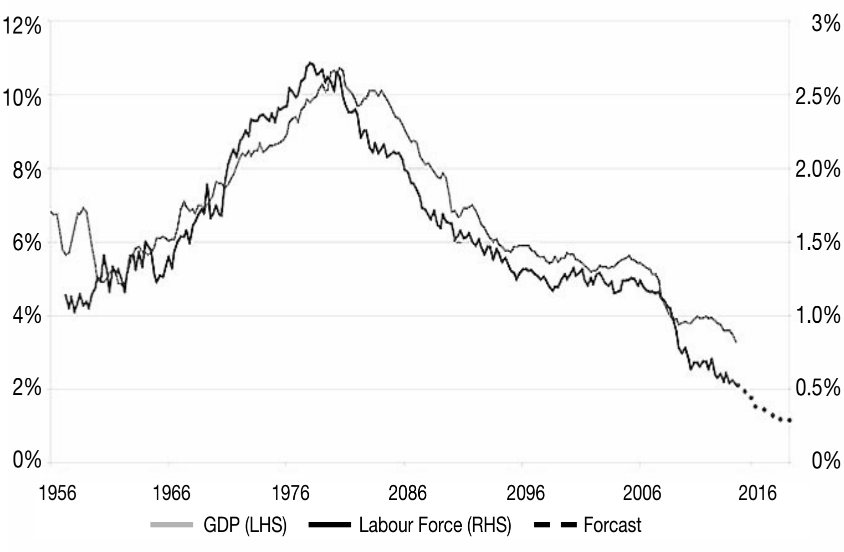
DEMOGRAPHIC DRIVERS

The demographic backdrop reinforces the low-rate story. Notice how the growth in the labour force has led nominal growth in the economy (see chart at top of page 3). Then notice how bond yields have tracked nominal growth (chart at bottom of page 3). We know where this is going: the population is aging, leading to slower labour force growth, leading to slower economic growth, resulting in lower bond yields.

This doesn't mean rates can't rise. They probably will increase over the next couple of years, but the increase should be limited. So, more bond bear markets are likely to happen. Should we be afraid of bonds? No. Over the past 60 years, our analysis shows that the top 10 worst bear markets



U.S.: Smoothed Growth in Nominal GDP & Labour Force



Source: Evercore ISI

in the Canadian bond market posted an average loss of about eight per cent. That's painful for investors who rely on bonds for portfolio stability. But those who have stuck with bonds through the worst times have recovered their money in an average of five months. That's months, not years. Contrast this with the S&P 500 composite index, where the top 10 bear markets over the past 60 years saw average losses of 34 per cent and it took 28 months, or 2.3 years, to recover losses.

DON'T FEAR BEAR MARKETS

So ride out bear markets. Don't panic. You can't time them anyway. But realize that a lower-growth world means lower returns going forward, be it for stocks or bonds. With growth more likely to average something in the two per cent area, rather than the good old Baby Boomer banner years when it grew above four per cent, bonds are more likely to provide average returns of around three per cent to four per cent and stocks around six per cent to eight per cent. Cash should continue to be the laggard. Sure, it will likely take longer than five months to recover losses in upcoming bond bear markets, given that yields are lower, so it takes longer to earn back losses. But that good old regular bond coupon will keep on working to consistently pay you for your investment.

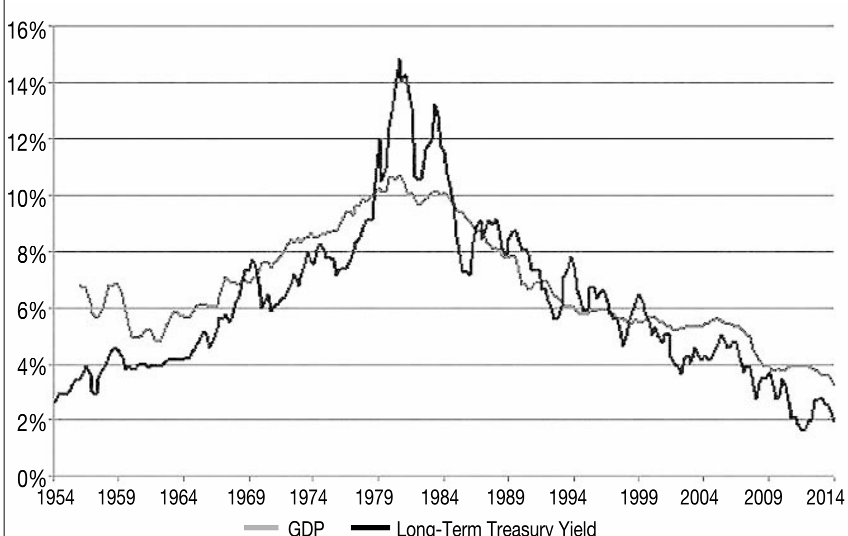
To boost your returns, look to the higher coupons available on investment-grade corporate bonds. Currently, corporate bonds offer an extra 1.2 per cent of yield on top of Government of Canada bonds (see chart on page 4). That's a lot. Historically, it's averaged about 0.8 per cent.

Investors are getting paid a decent amount of extra yield to compensate them for taking higher risk. That's fair. And with an economic backdrop that's improving enough to allow for higher interest rates, companies' earnings prospects are improving. This reduces the risk of investing in corporate bonds versus government bonds.

HIGH-YIELD LURE

For a bigger boost, consider adding high-yield corporate bonds to your investments. These are riskier companies (mainly in the U.S. market) that pay on average more than 4.5 per cent of extra yield on top of government

Yield on Long-Term Treasuries vs. Smoothed Growth in Nominal GDP



bonds. They're lower-rated, higher-risk bonds. But broad diversification through rigorous analysis of each company's prospects, credit metrics and bond covenants can result in a portfolio of high-yield bonds that can withstand higher interest rates better than their higher-quality (investment-grade) cousins. This requires a team of credit analysts with the experience to avoid the "junk" names in the sector, and focus on those that have the higher likelihood of maintaining the required earnings to make those high coupon payments, and sustain investors' trust to be able to roll over their high-yield debt at maturity.

Over the long run, you'll be happy. Companies offer higher yields than government bonds, and through the magic of compound interest, you should see much better returns by holding a majority of corporate bonds in your fixed income allocation.

We're in a different world. Lower growth. Lower interest rates. Lower returns. Risk hasn't gone away. But investors don't have to significantly change how they invest. They just need to recalibrate expectations and add some diversification to help boost longer-term returns. ▼