Manulife Investment Management

Episode 77: Eyeing the bond markets

Speaker 1:

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Kevin Headland:

Then the natural answer is that there is an opportunity to fixed income. Now of course, if you don't believe that, then that you need to readjust your portfolios to think somewhere else.

Macan Nia:

You just wasted 30 minutes of your time basically.

Kevin Headland:

Fixed income has surprised many investors this year, but not only producing negative returns alongside equities, but in some cases even underperforming equities after the worst start to the year in history, many investors are shunning the asset class, but we believe that's a mistake. In fact, investors should be taking advantage of an opportunity in fixed income that we haven't seen in quite some time. Not only are yields much higher than they were earlier this year for income generation, but should the bond market move the way we expect to over the next six to 12 months, there's also the potential opportunity to generate strong toll returns when it comes to investing in bonds, you need to focus on where we are going, not where we've been.

Listen on this is Investments Unplugged. Welcome back to Investments Unplugged. I'm your co-host and co-chief investments strategist Kevin Headland and joined once again with my other co-host and coaching investment strategist, Macan Nia. Welcome, Macan.

Macan Nia:

Hey, Kev. Hello everyone.

Kevin Headland:

How you doing?

Macan Nia:

How am I doing? I'm doing not that great, Kev. Market performance is really soured my mood, but when you're in the middle of the storm, the better weather is just around the corner, so just plugging the log.

Kevin Headland:

Well, maybe that brings us to our new segment in the news and I think yours has a lot to do with that comment you just made.

Macan Nia:

Yeah, so our new section where we talk about something that obviously is in the news as if it's a chess. And one thing I wanted to talk about is it has been a longer bottoming process than what we recently experienced with COVID, which has many investors asking at what point are we in this bottom domain process? And so what Kevin and I did, basically we went back to the 1950s, we looked at various bear markets and on average the time it takes for the market to really bottom is 240 days the current bottoming process so we're recording this on October 17th, 2022 and we're at roughly 200. So if we're using that as a benchmark, one can maybe thinking, not that we're going to use baseball analogies, we don't want to because of the horror show that unfolded two Saturdays ago now but let's not get into it.

We're probably three quarters of the way through. I saw actually a really interesting research report, Kev, and it was on basically Bank of America did this study and they looked at a whole host of signposts that typically go check mark for the bottom to happen. And just to give a couple of them. So this is from Bank of America, their US equity and quant strategy desks. So things like the Fed is cutting rates, unemployment's at a certain level are there more bears than bulls has a bear market rallied more than 5% over the last three months. PMI is improving. There's like 10 of them and right now historically of the sign posts, typically 80% of them are check mark and then the bottom has happened and this time around we have two or three of them. So that's also indicating along that has the bottom been reached? I hope so, but the data suggests that we're still a couple more weeks if not months of this bottom now process and Kev, as you always refer to now is not the time to get Q to try to time the bottom.

We're obviously much more closer to the bottom today than what we were eight months ago in this type of market where one may feel paralyzed in terms of how to invest, dollar cost is up strategy to deploy cash in this type of environment.

Kevin Headland:

And I hate to see maybe this time is different, but we tend to bottom when the data is fairly bad and this could be one of the most predicted recessions, shall we say, from equity perspective. But also it could be just staying near this bottom right, this sideways ish market because just because you hit bottom doesn't mean you snap back and recover V-shaped recovery. But I would say as you said, when the markets have done what they've done so far this year, we must be closer to the bottom than we were earlier this year for sure. Mine is similar to what you said. I think the storm, of course we've had some terrible hurricanes so far this year. One was even one of the worst ones I think in quite some time in Hurricane Ian and it's about the used car market.

Used cars have been really tough to come by of course since COVID with the delays and new cars and whatnot. But according to Cox Automotive, which is the parent company of Kelley Blue Book, they estimate that there could be anywhere between 30,000, 70,000 cars destroyed as a result of Hurricane Ian. So there could be a lot of interest in used cars because new cars still not available but interest in used cars as a result of the hurricane. So natural disasters, climate change exacerbating some of the issues that we're already having, especially when it comes to new cars and used cars.

Macan Nia:

That's interesting. So typically, do you know how many cars get destroyed in a hurricane or no?

Kevin Headland:

I don't actually. I don't have the data on average. The other thing that was actually interesting as well is for buyer beware of those looking for used cars, they might be flood damaged. So five, six months down the road, be careful when you're buying a used car. In the United States it could be flood damaged and it's actually illegal to sell a car without disclosing that is flood damage and actually a total write off you can actually rebuild the car but there's rules around selling cars that have been damaged by floods.

Macan Nia:

So let's transition and the theme of this podcast is why bonds and we don't have to relive the horror show that has unfolded in the fixed income market this year. I was reading actually something this morning where the 60/40, the balanced portfolio return is one of the worst in a hundred years. It has been a rough ride, but that's what's happened. We are October 17th, 2022 and given the selloff both inequity and bonds, we know what the decision should be today. But when we talk to advisors from across this country, there's a sense of paralysis, maybe not so from them per se, but even led by their clients. And there's a lot going on, there's a lot of uncertainty and Kevin and I were discussing the bond opportunity when we're thinking about the illustrative portfolio as of the end of September, we came down, we wanted to simplify it when things are this uncertain and there's a lot of complexity, sometimes it's just easy to simplify things.

And we looked at the bond opportunity through three, what we believe are simple questions and the first question is when we look at the policies that were put into place during COVID, whether it was monetary policy, fiscal policy or so on, did those policies have a structural change to the underlying global economy whether it was through employment, which we're seeing some of it today, whether it was through supply chains.

And when we go through all the questions related to that Kevin and I come to, the answer is, "No." Yes, it has created imbalances in the short term, but we don't think that COVID policies have structurally changed the employment market, have structurally changed supply chains, early indications of that. So a couple things we're looking at when it comes to supply chains, those global PMI that Kevin and I always talk to. One of the survey questions, Kev, as you know is how long is it taking you to get your products from basically your manufacturing plant to the end client and to no one surprised this measure was increasing through 2020, 2021 and now over the past really four to five months it's coming off and this can be a factor, this can be contributed to a couple things.

A slowing global economy, right? Less demand also when it comes to supply chains, supply chains are easing up. I know zero COVID policy in China is delaying it, but you think about even used car sales, impossible to get a used card before it. Now, it's a bit easier and look at your own personal life. So when we look at that first question, we don't think that C has structurally changed the global economy in the next five to 10 years. Yes, we're working through some imbalances today, but I don't think we're talking about those issues in two to three years.

Kevin Headland:

And I think you have to realize, well that was something we lived through that was exogenous shock. And as you said, it hasn't really changed a lot, but it hasn't changed the structural environment, especially when you think about disinflationary forces, right? Prior to COVID, central banks were trying to get 2% inflation. Where that's we're trying to get to for the bottom was we had no inflation essentially. And that's because of a lot of the structural changes. Now, because of COVID, we had inflation, but that should abate because the overall structure of the global economy tends to be disinflationary deflationary with technology, demographics, aging demographics, those are all disinflationary deflationary forces.

Macan Nia:

And then we asked ourselves a second question and the question is, do we believe that higher interest rates can result in lower inflation? The policies that many central banks across the world have started since really February March of this year by raising interest rates. Can we bring down inflation? And we believe the answer is yes and a couple reasons is well we're seeing it in the data. So for example, we've seen interest rates increase since March. You're seeing those global PMI slow materially across the world over the last couple of months. Also, when you look at inflation using an example so there's a very strong relationship with inflation, with commodity prices. Makes sense. And that relationship's really held over the past couple decades, really since the start of the year, we've seen a decrease in the commodity index. So the CRB commodity index inflation has potentially pivoted.

We believe if this relationship holds based on historical examples or relationships that CPI or inflation shift fall, another measure we look at is the NFIB raising prices. So in a nutshell, they ask small business owners in the US are you planning on raising, decreasing, or keeping your prices the same. And this has been obviously increasing throughout 2020 again over the last couple months, this has started to trend lower if the relationship with CPI holds, which is, and we have a note on our website that goes through all of these. So we encourage you to go look at it if you want to see the visuals, we believe that inflation will follow this downwards. And then also ISM prices paid. Again, you ask the manufacturers what our, they are paying for their input costs, whether they're increasing, decreasing or staying the same. Again, a very strong relationship.

If manufacturers are paying more for their input costs, they pass along to us. At the end of the day, this has been trending lower actually at a much stronger trend than the NFIB. We believe inflation shift follows. So when we ask ourselves that question, "Do we believe higher interest rates can result in lower inflation?" We don't believe that this dynamic has changed. This has been the case for all the previous rate hike cycles. We don't think this time is going to be any different. And Kev, I think you alluded to it too, is inflation averaged% I think it was 1.6 or 1.7% for the 10 years leading into COVID. And you mentioned the reasons big structural things such as demographics, technology, productivity, have those factors changed? And we don't think so. If anything, we've aged and add on top of that.

One thing we've done as governments, we've done as individuals, we've added debt, massive amounts of debt. And debt by nature is deflationary. I use myself as a perfect example. So bought a house during COVID massive mortgage in Toronto and I've been cursing the Bank of Canada at each one of these rate hike increases for multiple reasons. One of them being selfishly because I'm a variable rate mortgage owner and what my wife and I d, do we say, "Oh, we're not going to spend anything." No, we say, "If we had $1 to spend, we may have 95 cents." Now, that five cents goes to the good people at the bank. But that means there's five cents less in the broader economy in terms of the money supply. Now, take me, multiply me by thousands, millions of Canadians and then across the world you see the impact of the debt we've added in rising interest rates that in itself should also help with inflation.

Kevin Headland:

One thing that I don't think many realizes is inflation or CPI is a year over year calculation and it takes time for some of the impact of the center banks to feed through these inflation numbers. And it's a very delayed number. For example, one of the material I think is about a third of the CPI calculation is what is called owner equivalent rent. And it's a survey asking how much do you think essentially you could get for renting your home or property looking at shelter costs, right?

Now, those people responding have a recency bias, right? Because well if prices are recently higher than I'm going to say that I think I can get more money as much money as I can for my property as rental. That's not factoring actually the decline in overall housing prices. For example, case Schiller 20 city Compass index month over month, the most recent data as of July month over month was down 0.44%.

So actually a negative number so that should actually be deflationary essentially to the cost of shelter going forward. And that's only July number. We believe it's happened in the same thing of August, September. Again, that number is so delayed. So this data that we've seen, as you said, decrease in commodity prices, the small business survey as well as prices, paid ISM index, we're already seeing a lot of declines and we should see more declines going forward as this data becomes more recent and we actually are calculating the current event. So inflation should definitely be slowing, maybe not as fast as many would want or think, but we're starting to see demand destruction. We believe inflation has definitely peaked and will be slowing over the next few months.

Macan Nia:

And that owner's equivalent rent is not an insignificant amount of CPI data, it's 33% of that index. So it is going to be probably, if not the primary driver of disinflationary moving forward.

And then last but not least, the third question we ask ourselves is, "Do we believe the odds of a recession have increased throughout 2022?" And for us this has increased materially to us. It's not even a question of if we're going to get a recession, we're going to get a recession and it's likely going to happen. And the most called recession in the history of recessions it seems at some point early next year. The reasons we're saying that so many of you have seen our table of recession indicators in the US we take the view of it like a traffic light, right? Red, yellow and green. We update this quarterly and really throughout this year, the one was red was inflation and we had a couple pop up to be yellow. Employment has continued to be the green. And then at the end of September we actually downgraded two pretty big ones, inverted yield curve because it's been negative for three consecutive months.

Historically, a very good sign of a recession in the future and LEI's leading economic indicators went negative for the first time in the month of August. And on average the recession happens six months after that and then go through housing starts as likely to trend that way. Of all of these, the one that remains green is to the surprise that no one is employment. It continues to be very resilient, but not all of them have to turn red for the recession that happened. It's basically you're gauging it, right? And historically when we have this much that's read a recession's happening and one could argue being down 25% we factored in a recession. It's just a question of if you believe this is going to be a mild one, we may be closer to the bottom.

But if you think this is going to be a severe recession like the one we saw in the great financial crisis or in 73, 74 not our benchmark, there will be more downside if you believe that's the case. But we don't think that's the case. So do we believe the odds of a recession have increased? The answer is yes.

Kevin Headland:

And why does it really matter when we look at the odds of a recession increasing from a fixed income perspective? First off we expect the federal reserve is close to ending their rate tightening cycle by Canada close to ending their rate tightening cycle. More importantly, the majority of the future rate increases over the next couple meetings is priced in or likely priced into the bond market already. So that expectation that yields will continue to move higher is less likely, which has been the reason that bonds had a negative return earlier this year was the rising yield environment. So we believe that headwind is more so or more likely behind us in terms of fixing and returns. The other thing that's positive when we get a recession is yields tend to fall. And actually during recessions the tenure yield US treasury yield tends to fall by roughly a third.

And of course what was negative earlier this year with yields going higher and prices falling, if yields were to fall, prices will actually increase. And this is where the opportunity in fixing is that if we do get a recession, we could actually enjoy pause or returns, especially in higher quality, longer duration govern of bond securities.

Macan Nia:

And I think, and not to sound, I don't even know what the right word is, facetious or cocky, but why do we own bonds? And the reason I asked that is Kevin and I, obviously we run an illustrative portfolio. Kev, how has the bond performance made you feel?

Kevin Headland:

Oh, bond forums have been made terrible. It's supposed to protect on the downside when equities fall fixing them is supposed to manage or mitigate that volatility and mitigate that downside. And it hasn't done what bonds typically do when equity markets fall.

Macan Nia:

And I think everyone listening in can explain downside volatility to our end clients. We're used to it, we have practice with it, we really haven't had to explain fixed income, right? In these downturns we have our equity selling off, but the bonds have been there to provide support and clients have expected that.

And this time around it didn't happen. And when we talked to clients who say, "Listen, COVID was a once in a generational type of event that led to once in a generation type of stimulus. Look at our day to day lives was once in a generation we're stuck in our homes, we couldn't leave." Most of us, our jobs weren't impacted and we were able to save more. So it just basically led to a lot of money chasing the same amount of goods, if not fewer goods because of supply chains which led to in this inflation.

But sitting where we are today, you either have a decision as an investor, do you believe that the historical relationship between equities and bonds still exist? So during a selloff, the next selloff bonds will actually provide the support or have things changed so much because of COVID that bonds will continue selling off with equities. And we are not in that camp. We think that we own bonds for two reasons income, downside protection income. It's been there for us, right? Since the great financial crisis now we've been reaching or we've been adding risk for the level of income we've been gaining, right? That reach for yield with high yield, that's not the case today.

When you look at various bond indices across the world, they're paying you double or triple the income that you're getting as little as nine months ago. And then from the price appreciation perspective, again with yields coming up, if the odds of a recession of increase, which is our view, and if rates can decrease inflation, which is the answer to our second question, then if we get that recession, as Kev said, one would expect if that his or core relationship holds that interest rates come down.

So this is, I don't want to say the first time, but in the last 15 years, one could make the point that you have a total return of potential with bonds where you're getting not only the downside protection or price appreciation, but you're also getting the income. And we could put a case very easily together. And once you do that next Kev, that if you were to buy a bond today one year out, you can put down this thesis that you could be up anywhere between mid single digits to high single digits.

Kevin Headland:

Yeah, I think one of the things that investors maybe don't understand is really, well I think fixed income is asset class is difficult to understand. It's not as easy as equities I think for the most investors. But when it comes to fixed income, one of the things I enjoy and I like about it is that it comes down to math, right? Essentially what happens is that when you're investing in fixing them, you're lending a company, lending a country, you're lending them money and in turn they pay you an interest and then give you your money back at maturity when the bond matures. Now, unless the company or government defaults before that, you'll get paid back, you'll be paid whole. Right now, bonds are actually selling at a discount for the most part so you're actually getting less than a hundred cents a dollar, you're investing, you're buying the bond for less than a hundred cents a dollar.

Now, what happens is you get that paid the interest right now today and then when yields fall, it should yields fall. The mathematics behind it with duration actually adds total return. So I'll give you very simple, simple example. This is very broad strokes about how bonds work. Let's take if yields fall by a hundred basis points and your duration on your bond is eight years, that a hundred base points times eight years is equal to 8%. And if yields fall, that means an 8% price appreciation. Now, add on to your yield or income that you're getting when you bought that bond, let's say it was 5%, now you get eight plus your five, that's roughly a 13% return in that period during that one year. That's a very, very attractive opportunity.

Now, this is a very generalistic weight to view bonds, but I think a lot of people just look at it either as a income, like you mentioned, they don't think about the potential price appreciation. And now, we've gone through probably a 40 year bull market where yields only fell. So you're actually making a lot of money on bonds and this is one of the few times when the yields have actually increased in such a short period of time that had a negative impact on fixed income. And a lot of investors are kind of, why do I need 40% or why do I need any fixed income in my portfolio more? I will swap it for something else like GICs or cash or some other instruments.

And I think while those might have a place in a portfolio completely, they're placing bonds with those other asset classes is perhaps full hardy because of potential that exist in where we see things going over the next six to eight months. This is a very, very attractive and exciting time actually to be investing in fixed income. We have to ignore what has happened over the last eight months and look forward to what's going to happen over the next eight months.

Macan Nia:

And yes, it's easy to sit here with let's say new cash and say this could be the return profile over a year. But the vast majority of people listening on this line have 99% of their assets already invested in equities and bonds. So yeah, this is great. If I have new cash, I get it. What about the bonds that I own today? And depending on your bond, what decision you're down anywhere between 10% to 20% depending on the risk profile. Let's say, you're closer to 10%, 12% in the scenario that you are illustrating Kev, is it fair to say if I hold onto my bond for the next year, year and a half, I could be up mid single digits per year in a couple years time by not selling today?

Kevin Headland:

I think at least and I think if you analyze the returns, yeah I think it's very attractive. Some of the returns we're seeing, and this is where the portfolio manager adjusting their portfolios take advantage of some of these dislocations of the bond market. And it's less so about looking at the overall index, the individual opportunity that existing in specific individual securities and individual issuers of bonds. And I think this is where our active manager are, as I said, excited, this is an opportunity they haven't seen in quite some time. As you said, we used to have to reach for yield. This is showing a lot of opportunity right now in fixed income. And I think if we go forward one, two years from now and we look back and how well the fixed market is done, I think we'll be very, very happy. Even for those that have are negative returns right now, if they hold it through to next couple years, I think they'll be quite happy and we'll see that fixed AM has done its job.

Macan Nia:

Yeah, because that's a big one I get from advisors saying, "Yeah, we get it. Macan, that makes a lot of sense with new money." But what I tell my 80 year old client what to expect from bonds over the next couple years and our answer would be, "Don't sell." Like this is not the time to be selling that if you had that view, you should have been selling a year and a half ago. Right now is not the time. It just so happens to be when we're near these very extreme pain points, investors often do very silly things and the data suggested every single time. I think when it comes to bonds, this is one of those environments that yes, it has been extremely painful, probably has never been so painful for some investors from a fixed income perspective, but now is not time to panic. It's the time to understand what's going on to get a better gauge of what to expect moving forward.

Kevin Headland:

And I think it's one of the issues as well that perhaps investors look at the negative returns of fixed income and they mirror their experience in equities. And when equities are down, equities can fall further. But again, in fixed income it comes down to that mathematics and the calculations and say if you do believe that the worst from a rising yield environment is behind us and that default rates in the corporate credit or whatever bond you own is essentially nonexistent, then the risk of having negative returns becomes very, very minimal if at all. And I think that you have to understand that mathematics and really understand what are the risks of a next leg down and a further decline in returns in fixed income.

Macan Nia:

Let's go to that. So we have our view, we always talk about, and when we have our views as a 70%, 30%, right. We put a probability of 60% to 70% will be right and then others wrong. Where are we wrong, Kev? Where are we wrong? Where I buy a new bond today and in a year time I'm down 10% again. And I think the answer's pretty easy, right?

Kevin Headland:

It's extremely low. And the only way is that the center banks continue to raise rates and go way higher than anybody expects today.

Macan Nia:

Based on inflation that is at levels today. And if in this scenario that we're painting, inflation doesn't just stay at eight, inflation finds the next upwards.

Kevin Headland:

Moves higher.

Macan Nia:

So right inflation moves higher for whatever that reason is in inflation moves higher in an environment where the global economy is slowing because of higher rates forcing central banks to go from even current projections to even more. And when we look at the data, again, we think it could happen obviously, but we would put a low probability event of less than probably 10 to 20% on that. Whereas some clients are thinking it's 50% or plus.

Kevin Headland:

And it comes back to the questions, right? You said it. Ask yourself, do you believe that the worst is behind us? Do you believe that we're close to the end of rising yields? Do you believe that inflation is likely going to continue slow? Do you believe we're at risk of increased risk or recession? If you are on that side of the conversation, then the natural answer is that there is an opportunity in fixed income. Now of course, if you don't believe that you need to readjust your portfolios.

Macan Nia:

We just wasted 30 minutes of your time basically.

Kevin Headland:

So that's our views on fixed income, that's our views when we look at opportunity there. And I think that's something we have to reevaluate and realize that as Macan said, this is not the time to sell. This will be selling low essentially, which of course we know is not the right move for any investment opportunity.

Macan Nia:

And let's say that scenario unfolds where inflation ticks up, higher rates have to tick up higher. One could make a point that your returns are going to be better than what they were over the last 12 months, because now at least from that total return perspective, you have income to support some of that downside protection with new investments. So we don't think that's going to be the case. We think all the signs are showing. It's not a question of whether inflation's going to come down, it is going to come down. The questions are how quickly and to what level and in either of those levels, it's a good opportunity for bonds.

Kevin Headland:

Yeah, I think it's a great way to end it. I think again, you want more information on the case for bonds, why we should be owning fixed income in this environment? Please reach out to your Manulife Investment Management wholesaler. We can speak to the need for bonds. We're going to be doing more and more support for why owning bonds. But don't discount bonds in a portfolio. Look at the opportunity going forward, not necessarily where you've been. So once again, for investors unplug, I'm Kevin Headland.

Macan Nia:

And I'm Macan Nia.

Kevin Headland:

Thanks for listening. Till next time.

Macan Nia:

Take care. Bye.

Kevin Headland:

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