CIBC ASSET MANAGEMENT

IS IT TIME TO RETHINK BONDS?

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Summary

There are several reasons to think it is time to reconsider the role of fixed income within investor portfolios:

- Expected 10-year annualized returns to Canadian government bonds and various sleeves of fixed income are now competitive with equities on a risk-adjusted basis.
- With the back-up in yields, sovereign bonds are better positioned to provide investors with protection against future equity market drawdown risk.
- Fixed income covers a wide range of eclectic investment opportunities. Each one offers something different—for instance, an attractive expected yield, an expected illiquidity return premium, or lower duration and credit risk—that can help investors maximize diversification across their investment portfolio.

1. The recent past – glass half empty

Investor attitudes towards traditional fixed income portfolio solutions soured in recent years. Low expected returns, and high and increasingly pervasive inflation encouraged a reduction in investor allocations to core fixed income, in favour of public equity and more eclectic alternative solutions. Investor skepticism has been compounded since August 2020, as core Canadian fixed income has experienced its deepest and longest correction in the past seven decades (Table 1).

Table 1 – Historical drawdowns to Canadian fixed income

Period	Benchmark return	# of months	# of months to recovery
May 1958 to Sept 1959	-6.1%	16	9
Feb 1974 to Aug 1974	-9.8%	6	4
Feb 1975 to Sept 1975	-5.5%	7	4
July 1979 to Mar 1980	-11.1%	8	3
Jun 1980 to Jul 1981	-11.4%	13	4
Jan 1984 to May 1984	-5.2%	4	3
Mar 1987 to Sept 1987	-6.5%	6	4
Dec 1989 to Apr 1990	-6.1%	4	3
Jan 1994 to Jun 1994	-11.2%	5	10
May 2013 to Sept 2013	-5.3%	4	7
Mar 2020	-6.5%	0.5	3
Aug 2020 onwards	-16.5%	23	??
Average	-8.4%	8	5

The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg, Refinitiv Datastream. Data as at June 16, 2022.

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2. The present – glass half full

The fixed income landscape is changing. Sovereign bond yields have risen to levels last seen in 2018. Although investors have experienced capital losses during the current market correction, on a forward-looking basis bonds have become increasingly attractive (Table 2). The annual average return expected from a 10-year Canadian government bond over the next 10 years reached 3.6% in May 2022, up from just 1.9% in January. This is broadly comparable to the return expected from the U.S. S&P 500 over the same investment horizon in Canadian dollar terms, particularly on a risk-adjusted basis. The expected return for Corporates has also improved substantially, to above 5.0% from 3.4% in January.

Table 2 – Hypothetical expected returns to select fixed income & equity markets

Fixed Income	May 2022	January 2022
CN Money Markets	1.9%	1.4%
CN 10-y Government	3.6%	1.9%
CN Corporate	5.1%	3.4%
Canada Universe	3.9%	2.4%
U.S. Money Markets	0.7%	0.8%
U.S. 10-y Treasury	2.5%	1.6%
U.S. Corporate	3.9%	2.7%
U.S. High Yield	4.4%	3.0%
JPM World ex-Canada	3.0%	1.9%
JPM Emerging Markets	9.7%	8.8%

Equity	May 2022	January 2022
Canada S&P/TSX	6.1%	5.7%
U.S. S&P 500	4.1%	2.8%

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As well as offering a more attractive expected return, the increase in yields means that government bonds now have more scope to protect the downside of a Balanced portfolio during future equity market drawdowns (Table 3).

Table 3 – How much protection could core fixed income provide against future equity drawdowns?

Sector	Current 20-year nominal yield	Equity drawdown protection if yield falls to zero
U.S. Treasuries	3.33%	22.35%
Govt. of Canada	3.46%	23.60%

The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg. Data as at June 16, 2022. Calculations assume an illustrative 60/40 portfolio for a U.S. and a Canadian investor, with 60% allocation to domestic equity and 40% allocation to domestic sovereign fixed income.

Despite recent experience, synchronized drawdowns in equities and bonds are relatively rare (Table 4). Since 1956, there have been 21 equity drawdowns greater than 10%. Only during three of these episodes, including the current one, have bonds realized a concurrent significant drawdown. The current drawdown appears to be an exception, and not the rule.

Table 4 – Fixed income performance during periods of equity drawdowns[2]

Period	Equity return	Bond return
Aug 1956 to Nov 1956	-14.35%	-1.26%
Jun 1956 to Dec 1957	-26.90%	5.80%
Aug 1959 to Jul 1960	-14.59%	4.73%
Jan 1962 to Jun 1962	-17.02%	-0.31%
Feb 1966 to Sept 1966	-15.06%	1.24%
Jun 1969 to Jun 1970	-25.38%	4.29%
Nov 1973 to Sept 1974	-34.96%	-6.52%
Mar 1980 to Mar 1980	-17.64%	-1.25%
Jul 1981 to Jun 1982	-39.16%	11.31%
Jan 1984 to Jul 1984	-14.37%	0.41%
Aug 1987 to Nov 1987	-25.45%	2.09%
Jan 1990 to Oct 1990	-20.08%	2.46%
Feb 1994 to Jun 1994	-10.63%	-11.19%
May 1998 to Aug 1998	-27.47%	-0.11%
Sept 2000 to Sept 2002	-43.20%	18.52%
Jun 2008 to Feb 2009	-43.35%	3.77%
Apr 2011 to Sept 2011	-16.55%	7.72%
Sept 2014 to Jan 2016	-14.29%	6.06%
Aug 2018 to Dec 2018	-11.64%	1.54%
Feb 2020 to Mar 2020	-22.25%	-1.31%
April 2022 to June 2022	-13.01%	-7.34%

Equity: S&P TSX Composite Index. Bonds: FTSE TMX Bond Universe.
The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg. Data as at June 15, 2022.
[2] Drawdown is defined as a peak-to-trough decline of at least 10%.

Bond yields could yet move a little higher, if the flow of macro-economic data causes the market to price even more central bank policy action. Breakeven analysis suggests that current yields offer increasingly attractive protection against this risk (Table 5). For instance, short-term Canadian bond yields could rise 140 basis points (bps) above current levels before the 1-year expected return from an investment at this part of the yield curve would fall to zero; versus a money market fund, the breakeven is approximately 80 bps. For 5- and 10-year Government of Canada bonds, breakevens lie 81 bps and 39 bps above current yields, respectively.

Table 5 - Breakeven yield analysis

As of May 24/2022	Yield (%)	Duration (years)	Break-even (bps)
FTSE Short-term universe	3.89	2.77	140
Govt. of Canada 5yr bond	3.38	4.19	81
Govt. of Canada 10yr bond	3.48	8.84	39

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3. The future – A broad range of complementary fixed income solutions

Fixed income covers a wide range of opportunities. A large component of existing portfolio allocations focuses on domestic government bonds. Historically, this made intuitive sense: in the long-term, they provide a safe return, typically represent an effective hedge against drawdown risk in public equity, and offer a range of maturities that facilitate pension plan liability matching.

Investors are increasingly aware of the need to maximize breadth and diversification to ensure their portfolios can prosper in the face of a range of potential risks and opportunities. This means moving beyond a concentrated focus on traditional fixed income, and embracing complementary opportunities along the fixed income risk spectrum to enhance expected income and return, as well as adding geographic diversification into portfolios, for instance through allocations to Global Bonds and Emerging Market Debt.

Below, we highlight several fixed income opportunities that may merit inclusion in investor portfolios, alongside traditional core fixed income, depending upon specific goals and objectives. Each one offers something different—a higher expected yield, an expected illiquidity return premium, or lower duration and credit risk—that can help investors maximize diversification, both within their fixed income allocation as well as across their investment portfolio more broadly.

Short-term bonds

- Bond yields have risen in response to an increase in inflation, and an expectation of substantial central bank interest rate increases.
- Yields at the short end of the Canadian curve have moved to around 3%, double their level at the end of 2021. For investors parked in low-yielding cash or cash equivalents, this means that short-term bonds currently present an attractive opportunity to obtain much higher yield without significant addition of duration or credit risk.
- Although Developed Market (DM) inflation rates are likely in the process of peaking, inflation pressures are expected to remain above long-term central bank policy targets for the foreseeable future. Taking positions at the short end of the yield curve, where yields are less sensitive to changes in interest rates, can provide portfolios with a persistent hedge against inflation risk relative to exposures further out the yield curve.
- **CIBC Investment Solutions: CIBC Short-Term Income; Renaissance Short-Term Income Fund; Imperial Short-Term Bond Pool**

Corporate bonds

- Corporate bonds have historically provided a source of steady income and yield for investors. We expect this will remain the case. Corporate bonds continue to benefit from strong balance sheets and profitability, making the asset class relatively attractive at current valuations. Over the next twelve months, we expect corporate bonds to outperform government bonds.
- A focus on investment grade bonds can limit credit risk. The addition of high yield bonds can improve sector diversification and potential returns.
- An actively managed portfolio focused on high quality companies can manage risk through exposure to a broad set of industries and issuers.
- **CIBC Investment Solution: Renaissance Corporate Bond Fund.**

Commercial mortgages

- Commercial mortgages are loans secured by a direct claim on a commercial real estate asset. The most common asset types include retail, industrial, office, and multi-residential rental properties.
- Commercial mortgages offer relatively high and predictable cash flows tied to long-term leases. Investors also receive an illiquidity premium as loans are not readily tradable and are typically held until maturity. This also means that investors with better access to deals and origination capabilities can expect to improve investment returns.
- The asset class provides exposure to short-duration assets that typically exhibits both low volatility and low downside risk due to custom negotiated covenants, recourse to tangible property and additional guarantees from the borrower, as well as amortization schedules for loans which reduce principal repayment risk.

Chart 1 – Attractive correlations suggest investors can improve portfolio diversification by allocating capital to a broad set of fixed income solutions

	Core bonds	S/T bonds	Corporate bonds	HY bonds	Comm. mortgages	Private debt	Global bonds	EM bonds	CAD equity
Core bonds	1								
S/T bonds	0.08	1							
Corporate bonds	0.9	-0.07	1						
High yield bonds	0.25	-0.47	0.55	1					
Comm. mortgages	0.69	0.07	0.64	0.54	1				
Private debt	0.27	-0.15	0.45	0.43	0.32	1			
Global bonds	0.56	0.12	0.52	0.31	0.49	0.3	1		
EM bonds	0.4	-0.06	0.53	0.55	0.36	0.47	0.53	1	
Canadian equity	0.14	-0.21	0.31	0.69	0.05	0.54	0.16	0.51	1

The information was prepared by CIBC Asset Management Inc. using the following third-party service providers' data: Bloomberg Finance L.P.. Maximum sample is January 1973 to March 2022. All data expressed in Canadian Dollars. Core Bonds: CIBC Canadian Core Bonds Pool, Short-Term Bonds: FTSE Canada 91 Day T-Bills Index, Corporate Bonds: FTSE Canada All Corporate Universe Bond Index, High Yield Bonds: FTSE Canada High Yield Overall Bond Index, Commercial Mortgages: ACM Commercial Mortgage Fund, Private Debt:: FTSE EPRA NAREIT Index, Global Bonds: Bloomberg Global-Aggregate Index, Emerging Market Bonds: JPMorgan EMBI Plus, Canadian Equities: S&P/TSX Index. Correlation matrix equally weighted. .

- The outlook for Canadian real estate remains favourable, especially reflecting a strengthening of foreign demand.
- **CIBC Investment Solution: ACM Commercial Mortgage Fund.**

4. How our portfolios are positioned

CIBC Core Plus Fixed Income Pool

Core bonds

- We are overweight duration relative to benchmarks, as we consider market pricing of cumulative future central bank interest rate increases too aggressive. This includes the Bank of Canada.
- We are overweight IG corporate bonds, as we expect corporate bonds to outperform governments over the next 12 months.
- We have a preference for the mid-term part of the yield curve.

Corporates

- Wider corporates spreads now offer better value than a few months ago. We are overweight duration relative to benchmarks, with a preference for higher quality.
- We are slowly adding to higher beta names given attractive valuations. We are overweight energy given a favourable outlook for the sector.

High yield and credit

- We remain cautious in this sector but have started to put some capital to work to take advantage of market dislocations that have resulted in some higher quality BB names trading at favourable valuations.
- We have begun to add risk to economically resilient sectors, including packaging and healthcare. We are overweight energy and commodities, but underweight telecom given this sector's high leverage and capital expenditure budget.

Global bonds

- We are running risk below the long-term target, due to a continued uncertain economic and geo-political outlook.
- We are overweight commodity producing countries, such as Chile and Australia, reflecting a positive secular outlook for commodities.
- We expect economic growth to be particularly challenged in Europe as a result of inflation and the Ukraine war, and have expressed this view through an underweight to Italy.

Multi-Asset Absolute Return Strategy (MAARS)

- We are long Canadian, Australian, and U.S. sovereign bonds. The back-up in yields has improved expected returns associated with these positions, and a rising risk of an economic hard landing underscores the fundamental rationale of these positions.
- We are also long select fundamentally attractive Emerging Market local sovereign bonds, including Brazil, Indonesia, and Korea. All these positions exhibit attractive yields and underlying country fundamentals.
- We remain short DM credit. This position will benefit from a widening of spreads that is likely to result from the expected slowdown in global economic growth.

Let's connect

Should you have any questions about this report or anything else, please do not hesitate to connect:

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