Conservative+

December 2022 Edition

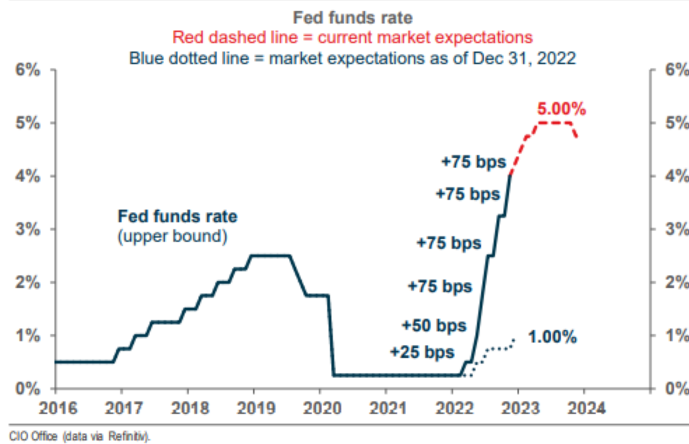
Bonds 101 ~ Laurel Hickey & Garth Bluekens

Comments from the CIO's office

Martin Lefebvre is National Bank Investments Chief Investment Officer and Strategist. Please see below for key takeaways from his December Asset Allocation update.

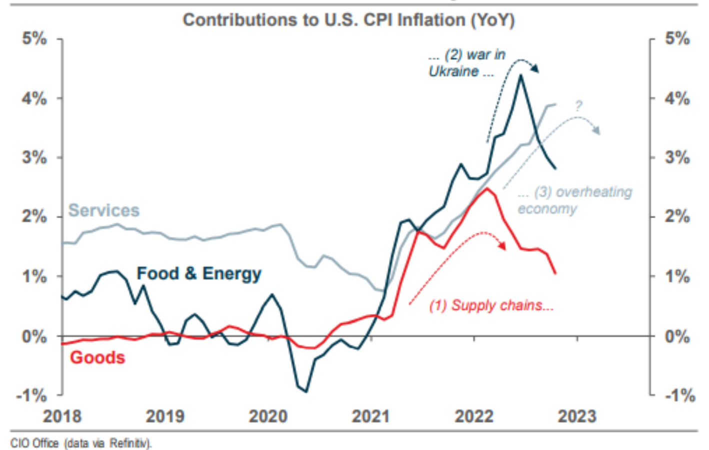
At this time last year, while the main theme of our annual outlook was the impending shift in central bank policy, little did we know that it was, in fact, a full-blown slamming on of the monetary brakes that was on the horizon for 2022. Thus, it is not 75 bps of hikes that the Federal Reserve has delivered this year (as anticipated by the markets as of December 31, 2021), but a whopping 375 bps... and counting (chart 1).

1 | Central banks slammed on the breaks...



Clearly, the Fed was caught off guard by the persistence of inflationary pressures. After starting in 2021 on the goods side (supply chains) followed by food and energy (exacerbated by the war in Ukraine that started in early 2022), inflation eventually migrated to services during the year, a symptom of an overheated economy (chart 2). The consequence of this inflationary trifecta: a four-decade high for the Consumer Price Index (CPI).

2 | ... in the face of an inflationary trifecta...



For investors, this hostile environment has left few places to hide, with most market segments posting losses after 11 months in 2022.

This is not the first time that stocks have experienced declines, and returns are no longer as negative following the strong rebound of recent months. For example, the Canadian market (-1.0%) has fared rather well, thanks in part to the good performance of the energy sector (+38.1%).

What is special this time, however, is that equity declines have occurred simultaneously with unprecedented losses for bonds.

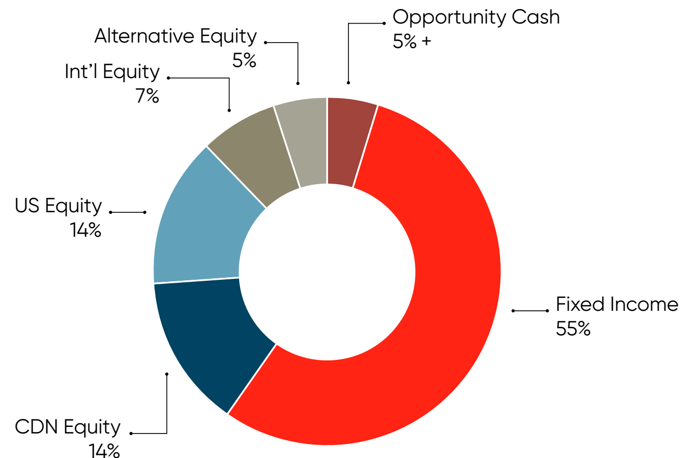
As a result, and to put things in perspective, the 12-month return on a reference balanced portfolio made of U.S. stocks and bonds is near its worst level since 1975; only the 2008-2009 financial crisis saw lower year-over-year performances. On the other hand, recall that this year's challenging backdrop followed a phenomenal rebound in 2020-2021 that was also virtually unprecedented.

What's Bonds 101 Got To Do With It?

In times of volatility, all eyes are on the stock market and the reasons it may go up or down in a day. The bond market may also experience its own volatility, but the average investor does not watch it as closely as the stock market. The stock and bond market usually move inversely to one another, as investors take their money out of the stock market, they may move it to a traditionally safer investment like a bond. What is different about this year, is we are seeing a downturn in both the stock and bond market. With rising interest rates, lower than estimated corporate earnings and a war, the stock market has had many reasons to experience negative returns. The bond market has also been experiencing negativity with rising interest rates causing the price of bonds to go down. This can hurt portfolios that have a higher allocation to fixed income, but it can also be an opportunity to buy bonds at a discount. If a bond is trading at a discount this means it is trading below its face value. When a bond matures, it matures at face value, so buying a bond at a discount could provide the possibility of capital appreciation if held until maturity.

To understand this more, lets look at what a bond is and how it works. When governments or corporations need to raise funds for something like a new capital expenditure, one option available is to issue debt through a bond. A bond is the promise to pay back the debt later and to also pay interest in the form of a coupon payment. The promise of the repayment later does add safety to bonds, but it is important to look at the financial stability of a company or government. If they are highly leveraged and don't have the means to pay back the debt, there is the risk that only a portion or none of the bond's face value will be paid at maturity. Therefore, looking at the different bond credit rating agencies in evaluating a government or company is important. Like any investment it is also important to determine if the asset class and allocation is appropriate for you. We want to make sure you understand all elements of your portfolio, so please let us know if you have any questions on bonds!

Conservative+ Investment Model Sleeve



Your Investment Policy CONSERVATIVE+: On the whole, you want fixed income investments. Although you can tolerate limited changes in the market value to ensure that your assets will grow, you prefer fixed income investments for reasons of stability. If you feel that your risk tolerance is shifting, please let us know!

Source: This information is for illustration purposes and subject to change. Your portfolio may not hold all of these positions. We enhance the composition of your portfolio with additional equity solutions that are not illustrated. The weightings change with market fluctuations and model rebalancing.

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