SUMMER 2022

Info SIGMA

The dynamics of the bond market

Bond prices are known to fall when interest rates rise. For example, a bond that offers a coupon of 2% will see its price fall if market rates rise to 2.50%. This is normal, since it pays less than the new bonds offered at the highest rate, it will be worth less.

So how do you explain that the increase in the Bank of Canada's key rate has resulted in a price rise for certain bonds in recent weeks?

The reason is that there are actually several interest rates. Bonds come in different maturities, each with its own interest rate level. In addition, each of these maturities reacts differently to a key rate rise, which is a very short rate (one-day rate) that central banks control. The different maturities and their interest rates form what is called the yield curve. The curve is usually on a positive slope, meaning that rates usually increase as bond maturities become longer.

In general, short-term rates follow the same trend as the key rate. So the variable mortgage rate for example will increase every time the bank raises its rate. But bonds with longer maturities, for their part, are more concerned about the risks of future inflation. The higher the fears of inflation, the higher the rates.

When the central bank makes its first- or second-rate hikes, the entire yield curve will tend to rise. On the other hand, for maturities starting at 3 or 5 years, the inflation outlook is also an important part of the equation. If the market believes that the increase in the key rate will help stifle inflation, following a sequence of consecutive increases, these rates will not increase, they will even often start to decrease. Therefore, a rise in the key rate will tend to raise longer term bond rates.

This is what we have been witnessing since mid-June. The bond market is beginning to believe that successive rate hikes will moderate inflationary pressures. Does this mean the downtrend for bonds is over? Only time will tell but having central banks finally taking action so decisively can be seen as an encouraging sign for the bons market.

Your Investment Advisors

Guy Lalonde, B. COMM, CAIA, CIM®
Senior Wealth Advisor
Portfolio Manager

François Beaucage, MBA, CIM®
Wealth Advisor
Portfolio Manager

Market review

There are plenty of uncertainties for the markets to keep track of these days. COVID refuses to go away and it looks like we will have to live with it for years to come. Its ability to evolve into new variants that each all the more contagious than the previous ones make community immunization a thing of the past. Who would have thought that more than two years after the start of the pandemic, we would be living through a seventh wave as waiting for an eight wave?

The Russian invasion of Ukraine muddies the waters further. Beyond the risks of the situation escalating into open conflict between the Sino-Russian bloc, the conflict is disrupting markets for oil, grain and specialty metals used for microchips manufacturing, the shortage of which practically halted the production of many products.

The sharp rise in inflation that we have witnessed since the start of the year further complicates the situation. Initially, central banks saw it as only a transitory price hike fueled by the reopening of global economies when vaccination became generally available. But it looks like inflation is more resilient than expected. Seemingly taken aback, the US Federal Reserve and the Bank of Canada went into catch-up mode, faced with already galloping inflation. This resulted in significant increases in key rates in a short time. The lack of action at the end of 2021 and this somewhat panicked catch-up has slightly weakened the FED's image in the eyes of certain economists and market participants. Some worry that the FED is so concerned about losing its good name as inflation fighter that it risks putting on the brakes harder than necessary, preferring to err on the side of excess rather than lack of action, which could trigger an otherwise avoidable recession, or to make such recession deeper than necessary.

The first six months of 2022 have been particularly difficult. Despite resilience on the part of certain asset classes that we hold, such as Canadian equities, dividend-paying equities, gold and the US dollar, the weakness of the stock markets in general and especially of bonds resulted in negative performances for the first six months of the year. A rebound since mid-June and throughout July/August has given us some respite.

The period was all the more difficult given that bonds did not help very much. On the contrary, their price has fallen more than most stock indices. Investors usually expect the bond portion of their portfolio to act as a safe haven during stock market corrections, providing some stability.

But this year, it was precisely a fall in bond prices that began at the end of 2020 that caused the stock market to finally fall in 2022. Such a bearish correlation is not new for the stage of the stock market cycle that we have just gone through. The dazzling economic growth since deconfinement was positive for equities, but the risk of inflation was negative for the bond market. In these circumstances, rising rates and interventions by central banks seeking to cool the economy will sooner or later get the better of the positive stock market trend. At that point, when the downtrend for bonds is already well under way, stocks join in their decline as investors fear that central banks will trigger a recession with their anti-inflationary interventions. This unpleasant period is usually short-lived. Indeed, when the banks have raised the key rate a few times, the bond market will have been in decline for a long time. The bond market eventually moves from worrying about inflation to worrying about a recession, just like the stock market. At that point, bonds find their ultimate low and start a cyclical uptrend, as longer interest rates begin a downtrend. Another indication that the longer-term bond market may have turned the corner is its positive reaction to the more recent short term rate hikes, as mentioned earlier.

This recent period highlights the importance of diversifying the portfolio among different types of fixed income investments, and not just holding fixed rate bonds. These represent only about 50% of the fixed income portion of our Sigma Balanced and Sigma Income baskets. The other types of fixed income that we hold, such as preferred shares, variable-rate back-to-back loans, or bonds from emerging countries, do not behave in the same way as traditional bonds, and have made it possible to minimize the impact of the rising rates since the end of 2020.

There are many pieces to the puzzle facing investors today, and several variables are novel to the markets. If forecasting the future has always been risky and unreliable, it is all the more so today. Dispersion among forecasts from various economists/strategists has never been wider, making them more unreliable than ever. Given the unpredictability of the markets which still continue to confuse economists and experts, holding a large number of asset classes and rebalancing them throughout market volatility is still the best strategy.

Rebalancing in the Sigma balanced and Sigma income portfolios

Year-to-date rebalancings have mostly consisted of profit taking in the TSX index, gold, dividend indices and our position in the US large-cap value-style stock index. These positions all acted as a safe haven during the volatility, and it then found itself in an overweight position on a few occasions. Bond positions and stock markets (excluding dividend indices) were rebalanced upwards.

Asset class rotation portfolios

The rotation portfolios managed to avoid the bond market rout. Since these did not offer any refuge during the market downturn, it was rather Canadian and American dividend stocks, gold, the Canadian stock market, and the American dollar which were able to show some resilience. Given that the basic strategy of these baskets is to invest in asset classes that have demonstrated a certain momentum or relative performance compared to other asset classes, it is these asset classes that have been present in the portfolios since the start of the year.

CELI APP

We receive a lot of questions related to the upcoming implementation of FHSA. Aimed at first-time home buyers, it combines the benefits of a TFSA and an RRSP. This measure will not be in place until 2023. We remain on the lookout for future developments in this area. We will keep you informed in a timely manner.

In the meantime, click **here** for an excellent article on the subject, written by Sophie Nicholls Jones published on the CPA Canada Website.

Happy reading!

Bulletin Board

- Congratulations to Marie Eve de L'Étoile for completing the registered representative course and training. Marie-Eve is only the second National Bank Financial associate to have obtained this distinction. This accreditation will allow Marie Eve to expand her role and responsibilities within the team, mainly with regard to market transactions. Congratulations Marie Eve!

- Congratulations to Andrée Anne Boulay for successfully completing her Securities Course! Successful completion of this course and the resulting certification will allow Andrée Anne to move on to the next stage of her associate profession. Congratulations Andrée Anne!

- We would like to welcome Marie Hélène Grenier, who joined the team a few weeks ago. Marie Hélène has 15 years of experience in customer service at National Bank. There is no doubt that Marie Hélène will be of great value to the team and to all of our clients. Welcome to the team Marie Hélène!

- **IN THE MEDIA:** Guy Lalonde had the pleasure of participating as a panelist at the recent conference organized by the Cercle Finance Quebec on the role and evolution of ETFs. To rewatch the conference, go to the website **https://cerclefinanceduquebec.com**/ under past events. Please note that the conference is in French only.

Do you know of anyone that could benefit from our services?
Don't hesitate to contact a member of our team!

YOUR TEAM

Guy Lalonde, B. Comm, CAIA, CIM®
Senior Wealth Advisor
Portfolio Manager
514-428-4327
guy.lalonde@bnc.ca

François Beaucage, MBA, CIM®
Wealth Advisor
Portfolio Manager
514-428-4314
francois.beaucage@bnc.ca

Marie-Ève de L'Etoile
Senior Wealth Associate
514-428-4308
marie-eve.deletoile@bnc.ca

Josée Arpin
Senior Wealth Associate
514-428-4325
josee.arpin@bnc.ca

Andrée-Anne Boulay
Assistant
514-428-4305
andreeanne.boulay@bnc.ca

Marie-Hélène Grenier
Assistant
514-428-4300
marie-helene.grenier@bnc.ca

Sans frais : 1 888 322-2522

NATIONAL BANK FINANCIAL
WEALTH MANAGEMENT

SIGMA MANAGEMENT
INDEX BASED SOLUTIONS
LALONDE-BEAUCAGE GROUP

CIPF
Canadian Investor Protection Fund
MEMBER