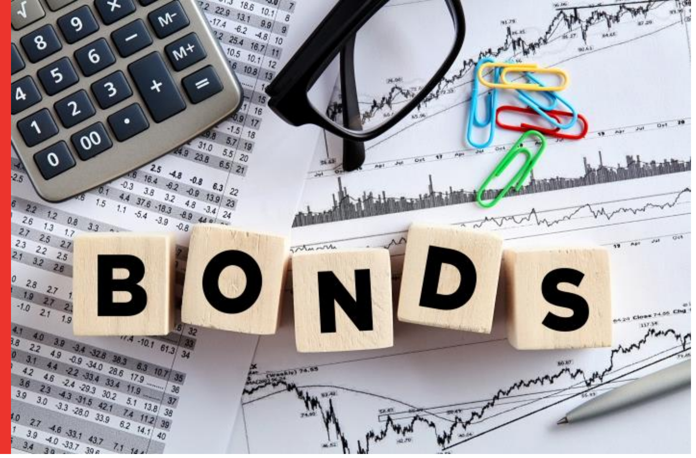
Time for a Fresh Look at Bonds?



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Stocks garner the bulk of the media's attention relative to bonds. Whether you watch BNN Bloomberg or read financial articles, most of the focus tends to be on stocks and the well-known stock indexes (Dow Jones Industrial Average, NASDAQ, TSX, etc.). Bonds tend not to be as well understood even though the bond market is substantially larger than the stock market.

Stocks represent ownership of a company. If you are the sole owner of a private company, you own 100% of the stock of that company. As an owner of stock, you are entitled to a percentage of the company's profits determined by your percentage ownership of the company. When a company generates earnings, it can reinvest those earnings to grow the company, or it can pay some (or all) of its earnings to shareholders in the form of a dividend. The value of your stock fluctuates based on the earnings of the company you own.

The perspective of a bond owner is different than the perspective of an owner of stock in the same company. If you own a bond, you want the company to do well, however, your return is limited to the interest and principal owed. Bonds represent ownership of the debt of an issuing company or government. The issuer of the bond (company or government) has entered a contractual obligation with you as a bond holder to pay interest (coupons) and principal over a specific period (term to maturity). At maturity, the company or government must repay the amount they borrowed plus any outstanding interest payments. It is this contractual obligation to pay interest at a specific rate that makes the price of bonds more sensitive to changes in interest rates than that of stocks. The price of bonds is inversely related to interest rates – as rates move lower, the price of bonds move higher and vice versa.

As shown in the chart, the US Federal Reserve has increased interest rates (blue line) to the highest point in ~20 years and to a level well above what's known as the 'neutral rate' (red line). A neutral interest rate is a rate which neither encourages nor discourages economic growth. Interest rates are set below neutral to encourage economic growth and above neutral to slow economic growth.

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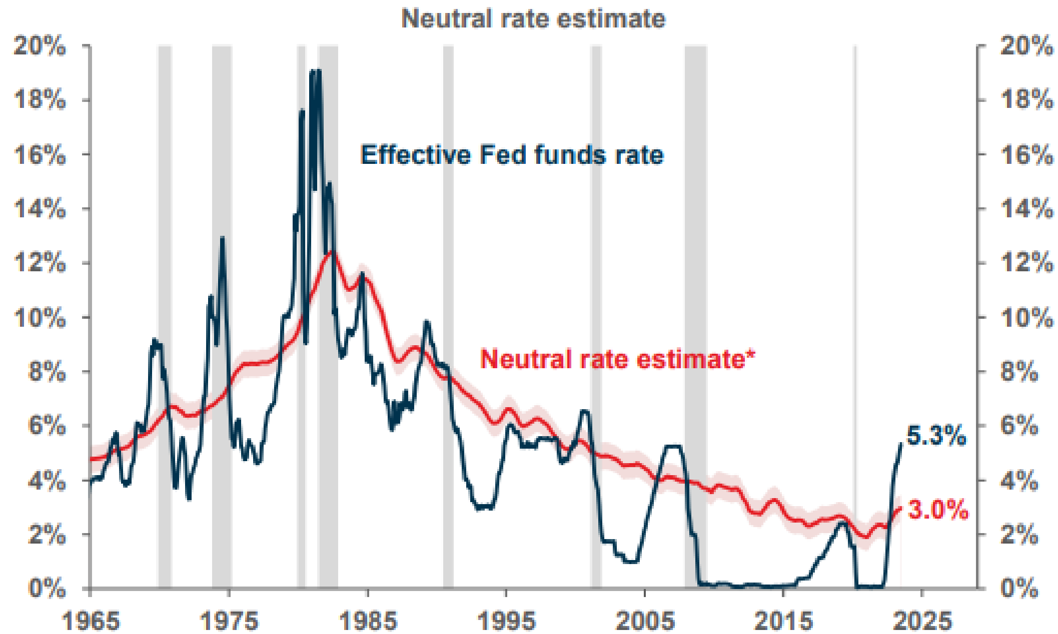

CIO Office (data via Refinitiv). * 50% economic estimate: Laubach-Williams model (before 2020), FOMC long-run projections (after 2020). 50% market estimate: 12-month moving average of the 5yr5yr forward Treasury yield.

Notice central banks reduce interest rates shortly after they rise above neutral and rates above neutral tend to coincide with the onset of a recession (grey shaded bars). The higher central banks increase rates above neutral, the greater probability they will cut rates in the near future in response to a slowing economy.

Because the price of bonds is inversely related to interest rates, bonds perform well when central banks cut interest rates in response to a weakening economy. While stocks are typically the star of the show, we may be nearing a point where bonds are ready to take the leading role.

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