Wealth Management
& Capital Markets Perspective

Wealth Management
Dominion Securities

For the clients of Grimes Handscomb Asset Management of RBC Dominion Securities | Winter 2024

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Is it time to get on the bond-wagon?

by Dagmara Fijalkowski, MBA, CFA

Over the past two years, rapidly rising interest rates have led to disappointing returns for bonds. We believe that the pain of this repricing is now mostly behind us. The backdrop for bonds is now the most attractive it has been in decades. The reasons for our positive outlook?

1. An intense tightening of monetary policy, including sharply rising short-term interest rates, is now behind us.
2. Bond yields and valuations are attractive.
3. The risk/reward for bonds is compelling.

We've already started to see a shift in the bond market in the last two months of 2023. U.S. 10-year bond yields have fallen over 1% since their October highs. Despite this rally, we still believe the case for bonds remains favourable in the quarters ahead. Overall, for investors who left risk assets or those carrying large cash balances, the current environment provides an attractive opportunity to invest some of that money in bonds.

Peak rates present an opportunity for fixed income investors

Since March 2022, developed market (DM) central banks have been raising short-term rates to tackle high inflation. However, this trend has shifted over the last few months. Many DM central banks have paused their rate hiking, while leaving the door open for future increases, if required. Others have suggested their next move may be to cut rates rather than hike. It is reasonable to assume that short-term interest rates are at or close to their peak for the current cycle.

We examined prior times the Bank of Canada reached peak overnight rates to see what this could mean for fixed income investors. We looked at two elements:

1. What happened to fixed income returns in the 12-month period following the last rate hike?
2. How did bond returns compare to short-term investments like GICs (Guaranteed Investment Certificates), which have become increasingly popular over the last two years?

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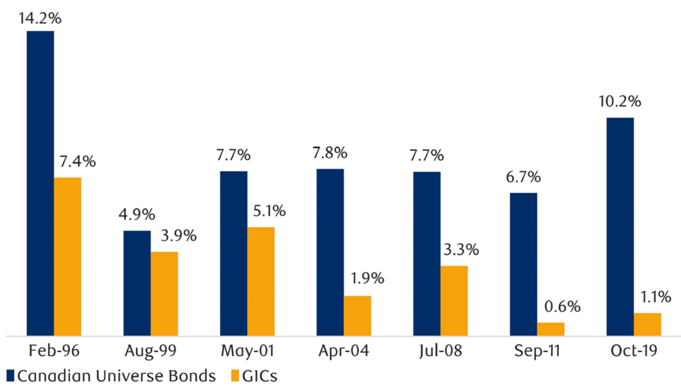
As Exhibit 1 shows, returns, both relative and absolute, have historically been very attractive for fixed income investors during the first year following the final hike in short-term interest rates.

1. On average, bonds have returned 8.4% in the year following the last rate hike, while GICs have returned 3.3%.
2. Bonds outperformed in all instances, by an average of 5%.
3. When short-term cash savings rates were as high as they are today, bonds outperformed, though occasionally by a smaller margin.
4. Interestingly, these fixed income returns are not front-loaded. They are spread rather evenly over the next 12 months.

Looking back through history, the period following the last rate hike has been a favourable environment for bonds.

Exhibit 1: One-year returns show bonds outperform following the last hike by Bank of Canada

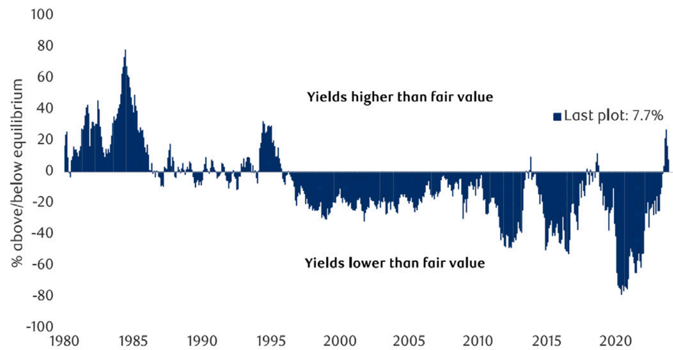


Note: Dates represent one year after peak Bank of Canada rate. "Canadian Universe Bonds" : FTSE Canada Universe Bond Index. "GICs" : the rate for a 1-year GIC when the Bank of Canada reaches peak rates. The graph does not reflect transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower. Past performance is not a guarantee of future results. An investment cannot be made directly into an index. Source: Morningstar Direct, Bank of Canada.

Valuations look attractive

RBC GAM developed a valuation framework to analyze where bond yields are trading relative to where they should be based on inflation and real rates. Exhibit 2 looks at this for the Canadian bond market. By this measure, bond yields have been overvalued for much of the last two decades. However, this shifted as rates have risen recently. The model now shows that Canadian bond yields are the most attractive they've been from a valuation perspective in many years. This valuation story is also true for most global bond markets, including the U.S. and Europe.

Exhibit 2: Canada bond market valuation
10-year government bond yield relative to equilibrium



Note: As of December 31, 2023. Source: RBC GAM

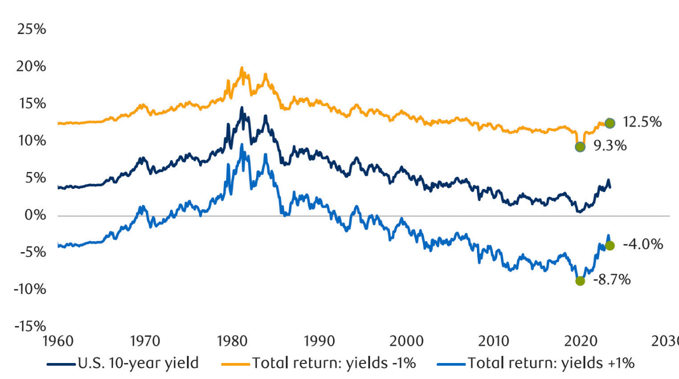
The risk/reward story looks compelling

Over the coming year, our base case expectation is for interest rates to fall as inflation continues to cool and economic growth slows. However, there is still a risk that inflation doesn't return to central bank targets, which could push bond yields higher. Yet even if yields were to continue to rise from here, the downside risk looks lower than in the recent past.

An example of this is shown in Exhibit 3. This chart illustrates the one-year return that a 10-year U.S. Treasury bond would provide if yields fall (yellow line) or rise (blue line) by 1% going back to 1960. Two time periods stand out:

- **2020**: bond yields reached their all-time lows in the summer. At that time a drop in yields of 1% would lead to a potential return of 9.3%. If they rose by the same amount, the expected loss was 8.7%. In other words, the upside or downside from bonds was about the same.

Exhibit 3: U.S. 10-year Treasury Bond
Total returns given +/- 1% shift in yields over 1-year



Note: Chart reflects hypothetical computation of total returns in the event that yields were either to rise or fall 100 basis points over the subsequent 12-month period. Source: Bloomberg, RBC GAM. Deutsche Bank as of December 31, 2023

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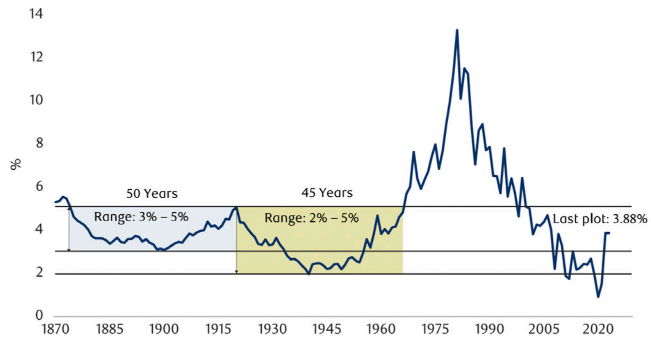
- **Today:** fast forward to today, this story looks a lot different. Based on current levels, if bond yields were to fall by 1% over the next year, the expected total return would be 12.5%. If bond yields rose by the same amount, the expected loss would be 4.0%, a much milder loss than the 2020 results.

This suggests that the risk is heavily skewed towards positive outcomes. The downside risk is significantly lower now than it was back in 2020, while the upside risk for bonds also looks more attractive. This, combined with our view that we're more likely to see yields fall over the coming year, provides an attractive risk/reward set-up for bonds.

A final word

As we've discussed above, at RBC GAM we believe that the major valuation risk for bonds is now mostly behind us. Even with the recent rally, bonds are the most attractive they've been in decades and the backdrop is skewed to the upside. For example, a move in the U.S. 10-year yield towards 3.5% over the next 12 months could still generate total returns in the high single digits.

Exhibit 4: U.S. 10-year bond yield



Note: As of December 31, 2023. Source: RBC GAM

After years of below-average bond yields, they are now well within their normal range of the past 150 years. At these higher yield levels, bonds can once again be a good source of income and offer the potential for capital gains should yields fall from today's levels. The importance of bonds within portfolio construction is once again evident.

More to come by Jim Allworth

The hard versus soft landing debate about the expected path of the U.S. economy is still going strong. We don't think it will be settled definitively until we get an official recession "start date" decision from the National Bureau of Economic Research. However, this typically comes about a year after the fact which makes it largely unhelpful from an investor's tactical standpoint.

For our part, we are persuaded that the combination of high rates and restrictive bank lending standards in place today makes a U.S. recession the most probable outcome. It is important to note that the Federal Reserve had already been cutting funds rates immediately before the start of nine of the past 10 recessions since the 1950s, so the arrival of the first Fed cut should definitely not be interpreted by itself as "Recession Avoided."

Meanwhile, the presence of similar conditions, i.e., high interest rates and restrictive lending, is already taking a toll in Canada, the UK, and the eurozone. GDP growth in all three was no more than a shadow of U.S. growth over the first nine months of 2023.

Of course, one can never rule out the possibility this time will be different. The extreme supportive monetary and fiscal policies introduced in response to the pandemic could conceivably linger long enough to keep the all-important household spending (70% of U.S. GDP) from outright retrenchment. Instead of a multi-quarter decline in GDP, the U.S. economy may do no worse than slow down this year.

That could be enough to keep S&P 500 earnings growing, although probably not by as much as the current consensus estimate for 2024 ($244 per share, up approximately 11% from 2023's expected $220) would suggest. (RBC Capital Markets' estimate sits at $234, up a more modest 6.4%.) We think any earnings growth would leave room for share prices to advance between now and the end of 2024, even if the path for getting there remains in debate.

For now, we recommend remaining sufficiently committed to stocks to take advantage of the distinct possibility of the S&P 500 and other major indexes reaching a new all-time high ground in the coming few months. However, we would consider limiting individual stock selections to companies an investor would be content to own through a recession, which, in our view, is the most probable economic outcome in the coming quarters. For us, that means high-quality businesses with resilient balance sheets, sustainable dividends, and business models that are not intensely sensitive to the economic cycle.

Perhaps the most compelling reason for focusing on resilient, high-quality businesses is that the economic and market valuation headwinds gathering will, in our view, run their course and probably fully dissipate later in 2024 or early 2025. Equity markets typically have anticipated the start of a new economic expansion several months before it gets underway. In our opinion, portfolios that have held their value to a better-than-average degree will be best equipped to take advantage of the opportunities that are bound to present themselves when a stronger pace of economic growth reasserts itself.

Administrative corner

Tips to streamline your tax reporting:

- Tax slips will be mailed beginning in early February 2024, until approximately the end of March. In addition to your tax slips, your tax package will include your fee summary, gain/ loss report and foreign property summary.
- Please provide the tax package in its entirety to your accountant. If you would like your accountant to receive a duplicate copy of your tax package, please let us know.
- For a more efficient and environmentally friendly option, consider switching to eTax. With electronic delivery, you'll receive your tax package securely via WM Online, saving time and paper. To learn more about this option, please contact us directly.

RBC Dominion Securities – Tax reporting schedule	
RBC DS completes all tax reporting by	March 31, 2024
Important personal tax deadlines	
Personal income tax installments	March 15, 2024 June 15, 2024 September 15, 2024 December 15, 2024
Personal income tax return filing	May 1, 2024
Self-employed income tax return filing	June 15, 2024
Balance owing for taxes payable	April 30, 2024

TFSA and RRSP information

TFSA information	
Maximum annual contribution limits	$5,000 each year 2009 - 2012 $5,500 each year 2013 - 2014 $10,000 for 2015 $5,500 for 2016 - 2018 $6,000 for 2019 - 2022 $6,500 for 2023 $7,000 for 2024
Maximum contribution limit since inception	$95,000 from 2009-2024, if born in 1991 or earlier and eligible resident of Canada during those years
RRSP information	
RRSP maximum annual deduction limit	18% of the prior year's earned income to a maximum of: $30,780 for 2023 – deadline February 29, 2024 $31,560 for 2024 – deadline March 3, 2025

Benchmarks

Equity market 12-month trailing return (for month ending December 31, 2023)	
S&P/TSX composite total return index	11.8%
S&P 500 total return (C$)	23.5%
S&P 500 total return (U$)	26.3%
DJIA total return (C$)	13.6%
DJIA total return (U$)	16.2%
Nasdaq composite price return (C$)	40.2%
Nasdaq composite price return (U$)	43.4%

RBC CM Canadian bond market indices 12-month trailing return (for month ending December 31, 2023)	
Short-term index	4.9%
Intermediate-term	5.9%
Three-month T-Bill (C$)	4.7%
Three-month T-Bill (U$)	5.1%

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