Investment Insights

Fall 2018

The path of interest rates and a "what if" scenario

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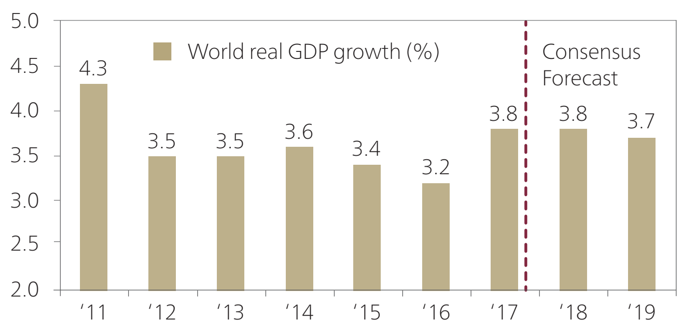
Bond yields have risen across most of the developed world this year. In the United States, the 10-year treasury yield has increased about 55 basis points and is now sitting close to 3%[1]. While not to quite the same degree, we also see that yields have moved higher in Canada, the United Kingdom and in a number of the larger continental European countries like Switzerland and Germany.

Many analysts suggest that the 35-year bond bull market is over now that U.S. bond yields have begun to increase from historically low levels. Some of the factors that have been placing upward pressure on bond yields have been gross domestic product (GDP) growth, tightening labour markets and inflation expectations.

A synchronous and robust economic recovery

The world economy is experiencing a synchronous and robust economic recovery. The 3.8% growth rate achieved globally in 2017 was the best rate of annual appreciation in GDP over the past six years (figure 1).

Figure 1: Global growth rates



Source: Bloomberg, 1832 Asset Management L.P. (as of May 31, 2018)

We are expecting 3.5% to 4% GDP growth in the world once again in 2018, with the U.S. leading the developed world at 2.8% growth while the emerging markets are likely to be led by India with a near 7% growth rate.

The unquestionable tightening in labour markets has been a natural result of strong global demand. The Organisation for Economic Co-operation and Development (OECD) reported that the global unemployment rate has declined to 5.3% from 8.5% at the end of the financial crisis.[2] This is the lowest level seen since at least the 1950s.

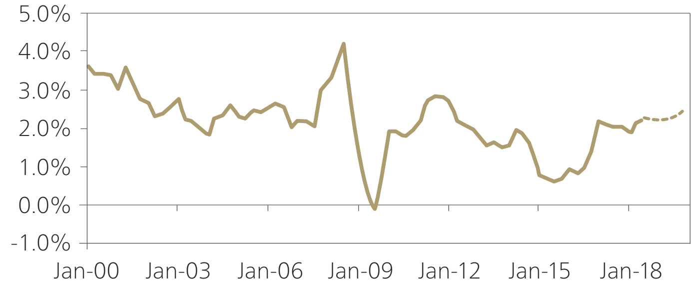
Several major economies such as the United Kingdom (4.2%), Netherlands (4.9%), Germany (3.4%), the United States (3.8%) and Japan (2.5%) all have lower jobless rates than the global aggregate.[3] Labour shortages are becoming an increasing problem as reported by employers across the United States, Europe and Japan. As it becomes more difficult to find qualified labour to fill vacant positions, we see wage growth starting to rise with a portion of these increases now being passed along to final selling prices.

America's impact on global bonds

It should really come as no surprise that developments in America impact global bonds given that the United States is the world's largest bond market. Anything that may lead to higher interest rates on U.S. treasury yields will reverberate around the world. There are two ideas that come to mind here. The first is the impact of the weaker U.S. dollar. The nominal trade-weighted U.S. dollar has depreciated by about 4% since the start of 2017 and this has placed upward pressure on imported goods prices. It takes time for a full pass-through, which means that even if the U.S. dollar begins to stabilize, we believe that the lagged impact of past dollar weakness is likely to filter through into inflation readings for at least the next three to six months (figure 2).

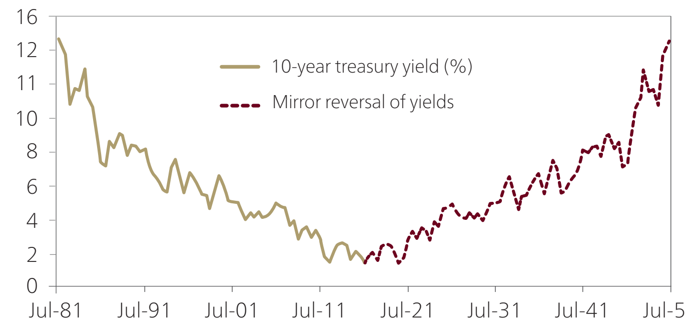
Secondly, with strong economic activity and rising inflationary expectations, global bond yields are likely to move somewhat higher over the next nine to 12 months. But, keep in mind that nothing in financial markets goes up or down in a straight line.

Figure 2: Global Consumer Price Index (annual inflation), with recent estimates



Source: 1832 Asset Management L.P., OECD, Haver Analytics (as of May 31, 2018)

Figure 3: 10-year U.S. treasury yields (1981–2016) and its mirror image (2016–2051)



Source: 1832 Asset Management L.P., Haver Analytics (as of May 31, 2018)

The "what if" scenario

In light of the movement in U.S. sovereign yields since its bottom in 2016, we decided to revisit the "what if" scenario analysis we did for a report we previously published. We assumed that the sovereign bond bull-run had ended in 2016, with the future path for interest rates simply mirroring what occurred since 1981 (figure 3). We also assumed that we purchased a 10-year U.S. treasury bond in 2016 and, at the end of each year, we sold our holdings and reinvested in the prevailing 10-year bond with any coupon payments (i.e. annual interest payments) also reinvested back into that 10-year bond. Before we get to the results, a quick reminder of what makes up the two components of a bond's total return:

1. Interest income from a bond's periodic coupon payments
2. Capital gains (or losses) from changes in a bond's value when the bond is sold, called or matures.

In our U.S. scenario of a 35-year bear market in the 10-year U.S. treasury, we found that over the course of the period in focus, the average total annual bond return was 4.3%, with the coupon of 6% more than offsetting the 1.7% price declines or capital losses. Our data for Canada is a little sparser so we projected out to 2043 (27 years). Here we found that total annual bond returns averaged 3.6%, with the coupon responsible for 5.2% of the total, again with the coupon more than offsetting the 1.6% price declines or capital losses. A rising interest rate environment is not necessarily a bad thing, as long as it doesn't happen in an abrupt, uncontrolled manner. Why? Because rising interest rates allow investors who need income to reinvest principal that comes due from their bonds at higher rates. Additionally, bonds have typically offered better downside protection and greater return certainty than equities and, when held to maturity, a purchaser knows how much money to expect (except in the event of a default, which is unlikely for most high quality bonds).

While the jury is still out on whether the long-term bond bull market is over, it seems prudent to opportunistically moderate interest rate risk in a fixed-income portfolio and reset return expectations for those with a three- to five-year investment horizon. Bonds continue to play an important role in balanced portfolios for long-term investors.

We'd love to hear your feedback. For any questions or comments, please contact your Relationship Manager or Bryan DeLaurier (bryan.delaurier@scotiabank.com) at 416.365.2991.

1 Bloomberg as of June 30, 2018.
2 OECD Organisation for Economic Co-operation and Development as of June 30, 2018.
3 Haver Analytics as of June 30, 2018.