TURNER INVESTMENTS COMMENTARY

Hon. Garth Turner PC

Senior Vice President, Private Client Group, Financial Advisor

416-346-0086

Douglas Rowat

Senior Vice President, Private Client Group, Portfolio Manager

416-777-6403

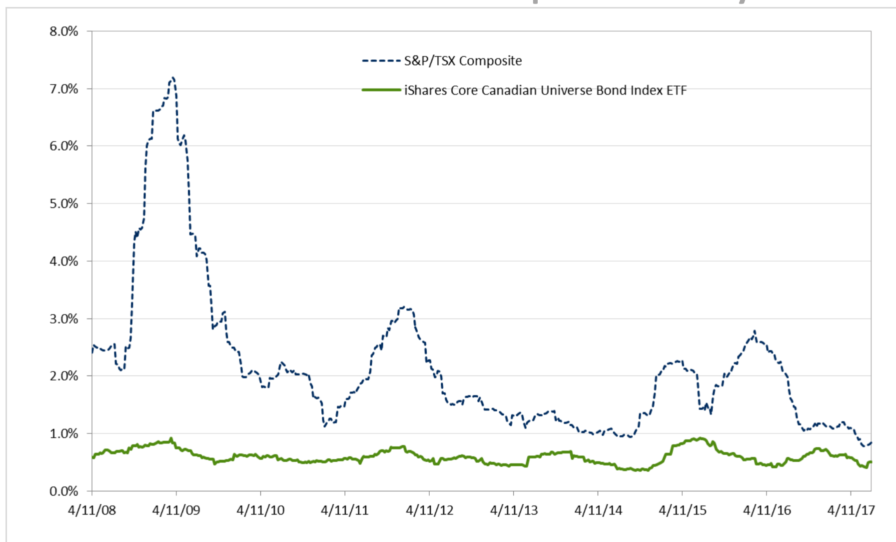
Ryan Lewenza

Senior Vice President, Private Client Group, Portfolio Manager

416-777-6416

BONDAGE

To be clear, you need government bonds—both federal and provincial—in your portfolio. They're low risk, provide a bit of income and, most importantly, tend to be negatively correlated to equity markets. In other words, they do an outstanding job of controlling volatility. As proof, below is the volatility of the iShares Core Canadian Universe Bond Index ETF (XBB), which is representative of the broad investment-grade Canadian bond market, versus the S&P/TSX Composite over the past 10 years:



Source: Bloomberg. Chart measures 6-month rolling standard deviation of the iShares Core Canadian Short Term Bond Index ETF and the S&P/TSX Composite Index. Standard deviation measures the amount of variation or dispersion within a particular index or security. In other words, it measures risk.

However, you've probably noticed that bond yields have spiked significantly over the past month or so, and took a particularly dramatic leg up near the end of June. This, of course, is a result of increased speculation that the Bank of Canada will be raising its benchmark interest rate. And indeed it did just that—a quarter point hike to 0.75%—on July 12. The sudden rise in bond yields (and hence a decline in bond prices, which is always the relationship between the two) has highlighted that not all government bond investments are created equal.

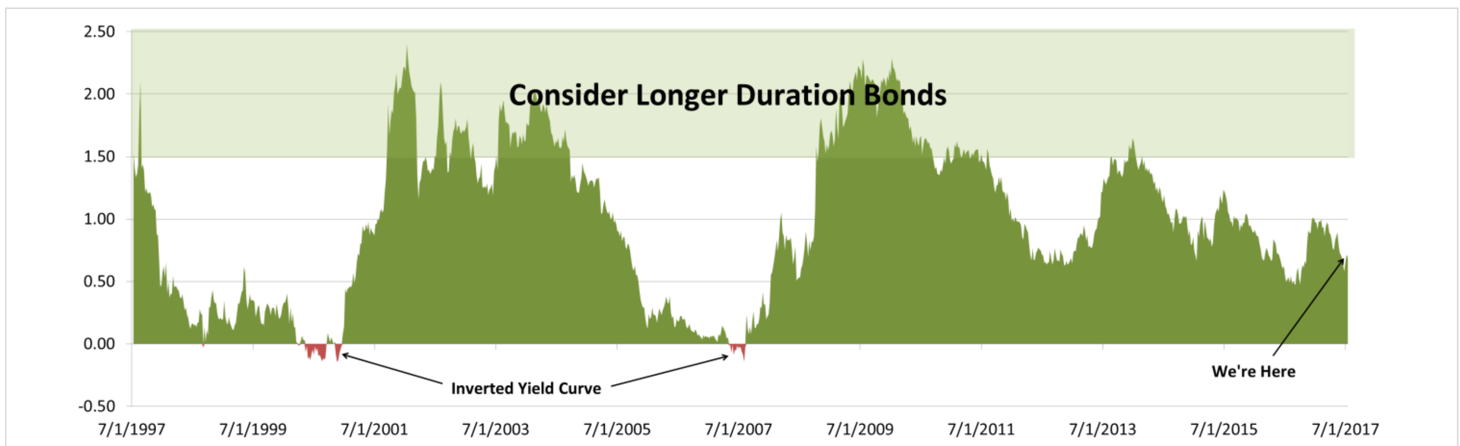
The iShares Core Canadian Long Term Bond Index ETF (XLB), for instance, has plunged more than 4% since June 26 while the iShares Core Short Term Bond Index ETF (XSB) has fallen less than 1%. This is because longer duration bonds have more sensitivity to changes in interest rates. Duration is a complex formula involving many factors including yield, coupon and maturity, but it is measured in years. The more years of duration, the more a bond's price will be impacted by interest rate changes. The XLB, for example, has a duration of 14.8 years while the XSB is at only 2.8 years, which explains the divergence in their respective recent performances.

When it comes to Canadian government bond exposure, we have focused most of our clients' portfolios towards shorter duration (short term) bond ETFs because we have felt for some time that interest rates will be moving higher and shorter duration bonds, accordingly, will have less downside risk as this occurs. However, at some point there comes a time when switching to longer duration government bonds is advantageous. So, now that interest rates in Canada are on the rise, when might we consider transitioning to longer-dated bond ETFs?

The simple answer is: when we're getting paid enough to make the switch. To determine if the payoff is sufficient, we look primarily at the yield spread between longer maturity and shorter maturity bonds. While long bonds have certainly become more attractive recently, we don't think we're yet getting 'paid' enough to switch over.

For example, let's look at the yield spread between the Government of Canada 10-Year Bond and the Government of Canada 2-Year Bond. While there's no absolute rule for when longer duration is more optimal, a yield spread of 150 bps or more often marks a compelling 'switch zone'. In other words, when the Government of Canada 10-Year Bond is yielding 1.50% or more versus the 2-Year Bond, such spreads have historically proven to be reasonable points to transition from short duration to longer duration. Indeed, if you had purchased the XLB in early 2010 (the recent highs of the yield spread) you would have outperformed the XSB significantly over the following five years (an 8.9% annual total return versus 2.6%, respectively).

Government of Canada 10-Year Bond Yield Minus Government of Canada 2-Year Bond Yield



Source: Bloomberg. Chart measures yield spread in percentage points.

Currently the yield spread between the 10-year and the 2-year sits at only 68 bps (or 0.68%). Not yet a compelling enough of an advantage, in our view, to swap short duration for long duration. Incidentally, the red shaded areas above indicate the rare instances when the 2-Year Bond actually yields more than the 10-Year Bond. In other words, an inverted yield curve. Such instances are predictive of recessions, but as you can see from the chart, no recession is currently indicated.

The Bank of Canada Also An Important Factor

While the yield spread is important, another critical factor in determining which bond duration we favour is what stage we believe we're in with respect to the Bank of Canada's tightening cycle.

Ideally, we would make a switch to a longer-dated bond ETF when the Bank of Canada was finished, or nearly finished, raising interest rates. The thinking here being that bond yields will generally have peaked towards the end of the cycle and that this would mark an opportune time to lock in higher yields.

Remember also that long-duration bonds are more sensitive to interest rate changes, but this sensitivity can work in an investor's favour if interest rates start to fall. In other words, long bond *prices* will advance more if the next likely actions from the Bank of Canada are rate *cuts*. Again, to take an extreme example, if you'd bought the XLB mid-2007 after the Bank of Canada had raised interest rates for an uninterrupted 10th time, the XLB then significantly outperformed the XSB over the subsequent five years as interest rates dropped (a 9.6% annual total return versus 4.8%, respectively).

Of course, we've thus far only had one Bank of Canada rate increase, so we're far from the top of the cycle. Looking at the past four tightening cycles from the Bank of Canada, which we define as at least three rate increases uninterrupted by a rate cut, the Bank raises, on average, 5.5 times each cycle. Therefore, in all likelihood, more rate increases are coming and it's not yet time to switch to long-duration bonds.

GETTING CLOSER, BUT NOT THERE YET

The Bank of Canada's decision earlier this month to raise its benchmark lending rate was undeniably an important moment for the Canadian economy. It was the first interest rate hike in seven years and it signaled that our economy has fully recovered from the oil price shocks of 2014 and 2015 as well as the 2015 recession. It also caused our dollar to strengthen and bond yields to soar. However, it's only one rate increase. The US Federal Reserve, by comparison, has already raised interest rates four times in the past 2.5 years, and the Bank of Canada as recently as the 2004–2007 tightening cycle raised rates 10 times. So we're in the earliest stage of the cycle and we see no reason at this point to adjust our core government bond holdings. We remain focused on shorter-duration bonds. If rates continue to rise, there will come a time when switching to longer-duration bonds is beneficial, but we're not there yet.

We've waited patiently for seven years for this first rate increase—there's no reason to rush portfolio changes now.

This newsletter has been prepared by Turner Investments, and expresses the opinions of the authors and not necessarily those of Raymond James Ltd. (RJL). Statistics, factual data and other information are from sources RJL believes to be reliable but their accuracy cannot be guaranteed. This newsletter is furnished on the basis and understanding that RJL is to be under no liability whatsoever in respect thereof. It is for information purposes only and is not to be construed as an offer or solicitation for the sale or purchase of securities. RJL and its officers, directors, employees and their families may from time to time invest in the securities discussed in this newsletter. This newsletter is intended for distribution only in those jurisdictions where RJL is registered as a dealer in securities. Any distribution or dissemination of this newsletter in any other jurisdiction is strictly prohibited. Securities-related products and services are offered through Raymond James Ltd., member-Canadian Investor Protection Fund. Insurance products and services are offered through Raymond James Financial Planning Ltd., which is not a member-Canadian Investor Protection Fund.

TURNER INVESTMENTS OF RAYMOND JAMES LTD.

40 King Street West
Suite 5300, Toronto, Ontario M5H 3Y2
Tel: 416-777-7000 | Fax: 416-777-7020

www.turnerinvestments.ca

TURNER INVESTMENTS | RAYMOND JAMES®