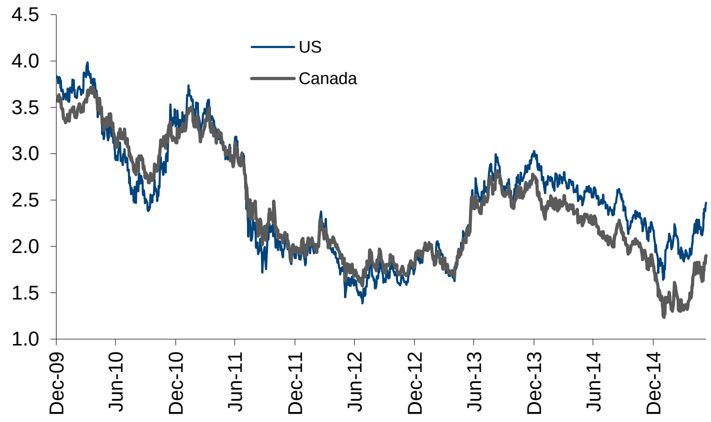
Bond Yields Toll for Thee

June 11th, 2015

The TSX & S&P 500 have been rising for over six years now, making this one of the longer bull runs in the history of bull runs. The bulls within our investment team, currently outnumbering the bears, have some pretty strong arguments for a continuation of the cycle. 2008/9 was a credit driven recession, followed by a deleveraging phase. This stunts the recovery, making it much flatter or slower than normal and has in the past caused elongated bull cycles. To be fair, there really aren't any excesses in the economy to raise red flags. Plus, if you look at the vast majority of the indicators we discuss monthly, 21 are positive while only 5 being bearish. So we remain very confident that the economy remains on a healthy path with a very low probability of recession in the coming quarters. Sure the Canadian economy is being hurt by lower energy, but these lower energy prices are still a gradual dividend to the global consumer. A strong U.S. dollar may hurt the profitability of many U.S. companies, some of which we own, but a higher U.S. dollar exports growth to other regions such as Asia and Europe, which is a longer term good. This would be the rosy, happy world economic view.

But we don't invest in economies, we invest in companies and that has worked out extremely well over the past five years. The U.S. and Canadian economies have expanded by about 20% during the past five years while the TSX has risen 47% and the S&P 500 by 115%. The stock market is levered to the economy, which does make the swings bigger. However over the past five years, investors have enjoyed another key recurring ingredient – low bond yields.

Apart from a couple brief spats, bond yields have spent most of the past five years moving lower



Source: Richardson GMP Asset Management, Bloomberg

Connected Wealth Market Ethos posts are market thought pieces from the Richardson GMP Asset Management team. As part of our philosophy for managing money, we believe in providing quality objective advice and services with greater transparency. These reports are designed to provide a deeper look into our current thinking.

Market Ethos - Ethos is defined as the character or disposition of a group. In this case it's the disposition of the market itself.

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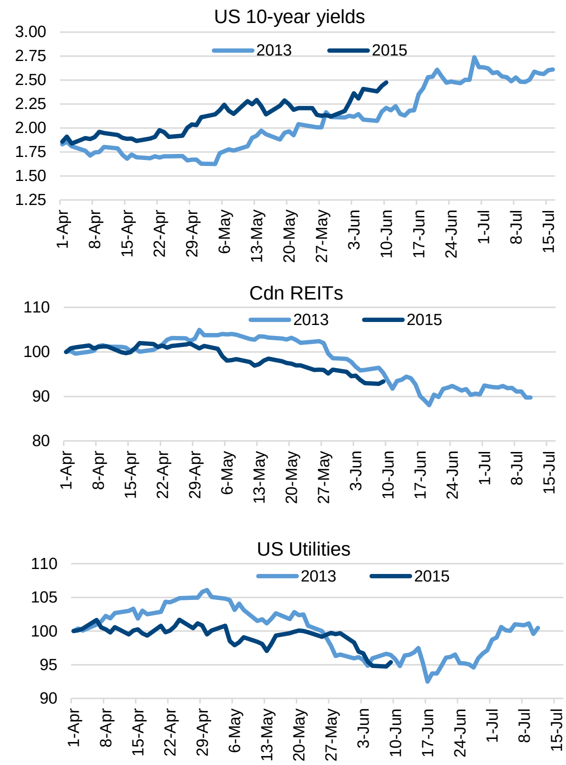
Lower bond yields was in part by design. Lower economic growth and demographics certainly contributed. But to keep growth going during this deleveraging phase, the Fed and other central banks embarked first on cutting rates to zero (ZIRP = zero interest rate policy), then Quantitative Easing (QE). This also helped offset the impact of the banking system becoming more restrictive primarily due to legislations such as Basel 3 and Dodd Frank. Most would agree this unprecedented monetary stimulus has worked in the U.S. and continues to contribute to recoveries in Europe and Asia. Yeah!! The U.S. has stopped QE and is getting closer to ending its ZIRP. Yet these policies remain in full force in Japan and Europe.

Play it again Sam – 2013 Taper Tantrum vs 2015



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Our concern in this article centers on the potential side-effects to these initiatives that may start to become noticeable now that we are nearing policy divergence (no more ZIRP in the U.S.) and with bond yields moving higher. We also believe these "side-effects" have portfolio strategy implications that may require a different approach in the coming years compared to the last few years.

Equity Market – Do Bond Yields Toll for Thee?

We do believe the current bull market has legs, and on a relative basis equities remain our preferred asset class. Bond yields moving higher in a still low inflationary environment is actually a normal, natural and good event. However, we are concerned about the impact of both higher bond yields and an end to ZIRP on the equity markets, specifically how they will react in both the short and longer term.

Short-Term - We have seen this before and there are some similarities with the Taper Tantrum of 2013 (charts to the right). It did occur roughly at this time of year in 2013 as bond yields began rising in May. Not surprisingly the most interest rate sensitives took the brunt of the damage, as we are seeing this go around. In addition to bonds, weakness has been acute in REITs, utilities and telecom.

Not that things always go the same way, but in 2013 the equity markets ignored higher bond yields for almost a month before the pain spread to the broader markets. The TSX weakened first, then the S&P. We are seeing similar patterns this go around as well which has us leaning towards being more defensive in the near term. Add to this, the S&P 500 is trading 17.8x forward earnings and the TSX is 18.5x. These are not overly expensive valuations but if bond yields rise, and you believe as we do that a company's value is based on its future free cash flows discounted back to the present….well higher yields beget a higher discount rate and lower valuations.

Our cautious stance near term is counteracted by our view that this cycle has legs which is good for equities. So if we do see broader market weakness develop, we are going to be buyers. In the Taper Tantrum of 2013, the TSX declined almost 9% and the S&P 500 by 7.5%. Currently, the TSX is off 3.7% and the S&P by 1.2%. Not that we believe history repeats itself exactly, but if we see declines above 5-7%, we will be doing some buying.

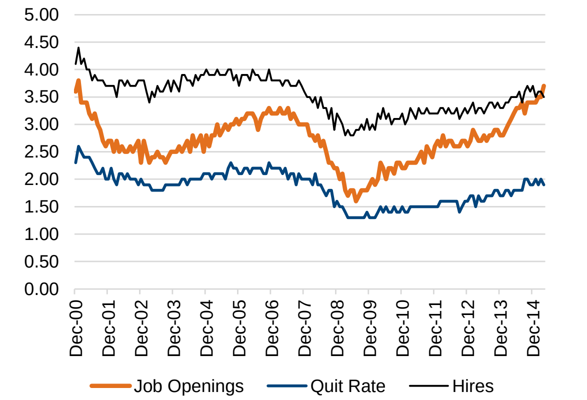
Longer-Term – We think this rise in bond yields can be characterized into two different scenarios which we will call "Cat on a hot tin roof" OR "Real Change".

Cat on a hot tin roof Scenario – For the past few years, every time bond yields started to move higher on better data, many have jumped into the camp believing the secular bull market in bonds had turned bearish. Only to realize the mendacity of the bond yield move, and watch yields resume their downward trend (FYI - a recurring theme in the play was deceitfulness). Bond yields may reverse their recent rise as many economic data points are not very strong. U.S. GDP shrank in Q1, retail sales have been soft and there is certainly slack in the economy. The Citigroup Economic Surprise Index has been improving for the U.S. but remains deep in negative territory. Internationally, China is slowing. Europe's recent spat of good data may prove fleeting. And of course if we have a surprise from Greece or other geopolitical shock, money will flood into U.S. Treasuries and push yields back down.

Real Change – We do not believe the rise in bond yields is a false move and believe real change may be afoot. This has some pretty important investment implications. The recent move in yields has largely been on the back of higher global bond yields. This may prove a temporary or a fleeting driver of North American yields. However, the soft U.S. economic data in Q1 is also going to be fleeting and if the pendulum swings more positive, yields could move another leg higher.

We are starting to see tightness in the U.S. labor market. The unemployment rate has declined to a level where further declines are expected to elicit wage inflation pressures. Meanwhile, job openings just reached their highest level since the data began 15 years ago. We just had our highest wage growth reading since 2011. This all augers for higher yields and we could see a greater upside move than many are expecting in the past. The consensus forecast for the 10-year Treasury yield in Q2 is 2.20%, meanwhile it is already 2.48%. Q3 and Q4 forecasts are 2.37% and 2.49% respectively.

Wage Pressures are coming



Source: Richardson GMP Asset Management, Bloomberg

If bond yields are moving to a more "normal" level given economic activity, say 2.5-3.5% on a sustained basis (or even 4%?), this certainly has portfolio implications. A tougher go for bond allocations would be top of mind and all the more reason to remain underweight duration. It would also put downward pressure on the more interest rate sensitive equity investments, namely utilities, telecommunication services, pipelines and REITs. For dividend focused strategies this carries a greater importance given these are popular sources of dividend yield. Not all dividend payers are the same, some react very negatively to higher bond yields (Interest Rate Sensitives) while some do not (Cyclical Yield).

Spectrum of Interest Rate Sensitivity

Source: Richardson GMP Asset Management, Bloomberg

To measure interest rate sensitivity, we took Canadian equity industry groups that have an attractive dividend yield. These are ranked based on a combination of two factors, the correlation to bond yields and the sensitivity (degree) of changes in bond yields. We included the broad markets, measured by the TSX and S&P, plus a few bond ETF strategies. This spectrum (left) is ranked by the most interest sensitive to the least. We would call the least sensitive as Cyclical Yield. Now we can debate the exact ranking of certain sectors but the real take-away is portfolios should be tested to ensure they are not overly exposed to the Interest Rate Sensitives and consider adding Cyclical Yield to help balance this risk.

M&A at risk, look to organic growers

This is a thematic we are researching and will be discussing more in the coming months. The good news is we believe this theme is early and may play out over the next few years, so no rush at this point. We would also welcome feedback or thoughts on this thematic (just email me craig.basinger@richardsongmp.com).

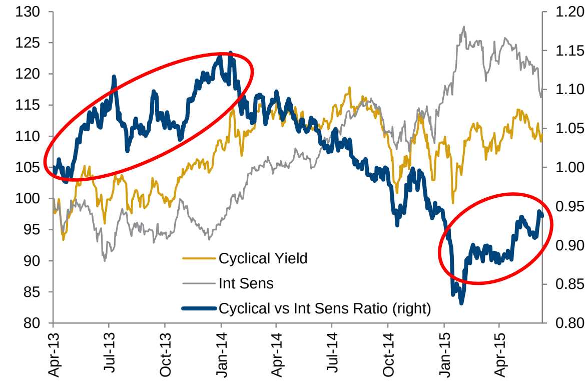
So far this year, mergers and acquisition (M&A) activity is at $2.3 trillion globally which is up 22% over last year and if this pace continues will set an all-time record. The environment has been perfect for M&A. Corporate confidence has been gradually improving. Thanks to low yields and QE, the debt markets are awash with liquidity, making the market very receptive to bond issuance, including high yield, for companies doing deals. However the greatest driver of this increased M&A activity is a lack of growth. Nominal GDP has been growing at a frustratingly slow pace during this recovery which makes it more difficult for companies to organically grow their business. The solution for many was to leverage easy debt markets and buy other companies to foster growth. Normally, according to the text books, when an acquisition is announced the target's share price rises and the buyer's declines as it tends to be dilutive to earnings (as they have to pay a premium to get the asset). But in a market lacking growth, with the cost of capital from the debt market artificially low, both the buyer and seller can see their prices rise.

Our concern is no more QE and ZIRP, combines with better economic data to move yields higher. With a better economy more companies should be able to grow organically. With higher yields, the cost of capital for conducting M&A rises, reducing the benefit to the purchasing company.

The growth through acquisition model has been the dominant strategy over the past few years. This may be about to change and investors may want to start looking to those companies that can grow without buying others, the organic growers. [Stay tuned for more on this]

Conclusions

A repeat of the 2013 Taper Tantrum? Balance the interest rate risk with Cyclical Yield



Source: Richardson GMP Asset Management, Bloomberg

- Bond yields have risen on the back of higher global yields. If the North American economic data improves, we could see another leg higher in bond yields.
- So far the pain from higher yields has been isolated in the more interest rate sensitive investments. This may spread to the broader markets if yields continue to rise.
- The labor market and other economic data is supporting higher yields. We would be mitigating this risk by remaining short duration within bond allocations and focusing more on Cyclical Yield for dividend strategies.
- Within the Connected Wealth portfolios, we remain very low duration on bond allocations in both our pure bond and balanced mandates. Over the past six months, we have been reducing interest rate sensitive equities such as REITs and Telcos while adding to more Cyclical Yield areas including insurance, regional banks, industrials and chemicals.
- If bond yields remain in a more normal range and economic growth improves, longer duration investments and growth through acquisition strategies may be tested.