TD Asset Management

Commentary 10 Minutes

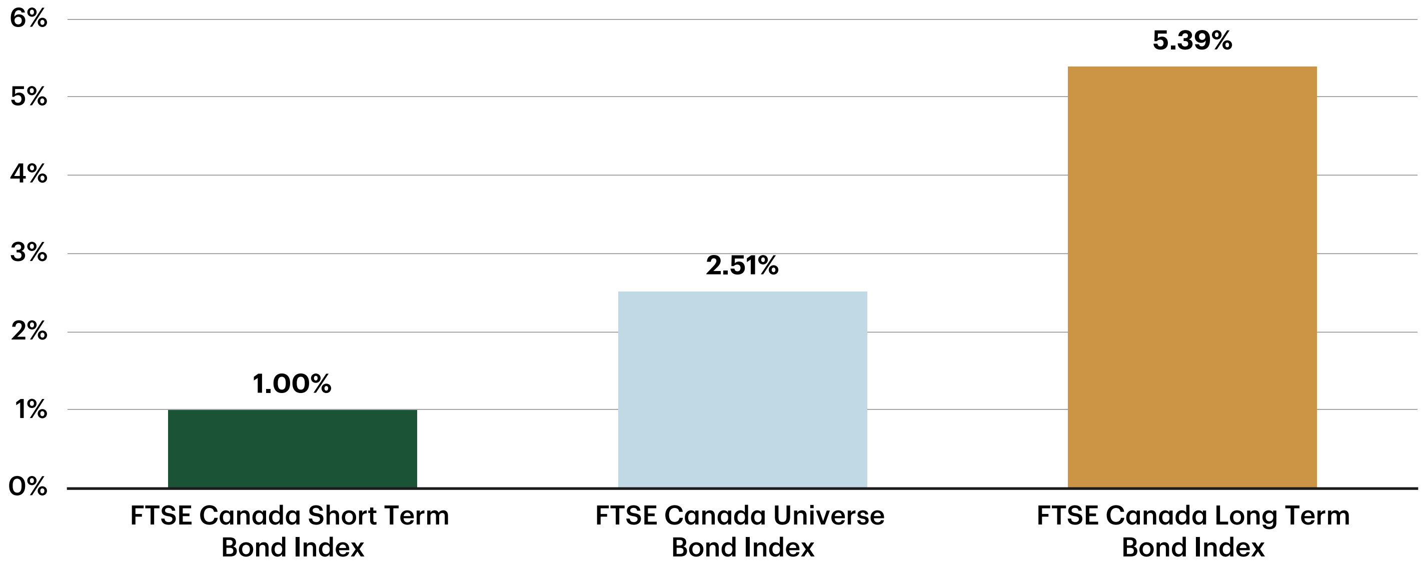
Looking Past Face Value: The Opportunity in Bonds

Bonds faced a difficult year in 2022 as central banks embarked on one of the fastest rate hiking cycles experienced in decades. As bond prices move in opposite direction to interest rates, the rapid rise in interest rates caused bond prices to fall, making last year one of the worst years on record for bonds.

Despite last year’s challenges, one of the areas that the Portfolio Adviser (“we”, “our”) see tremendous opportunity in 2023 is within bonds. At the start of the year, we anticipated that the prevailing environment of receding inflation and slowing economic growth would potentially provide a solid foundation for bonds to deliver positive returns in 2023.

As we anticipated, bonds have generated positive returns year-to-date (“YTD”) with long-term bonds recording stronger returns than short-term bonds.

Chart 1: Year-to-Date Canadian Bond Market Returns

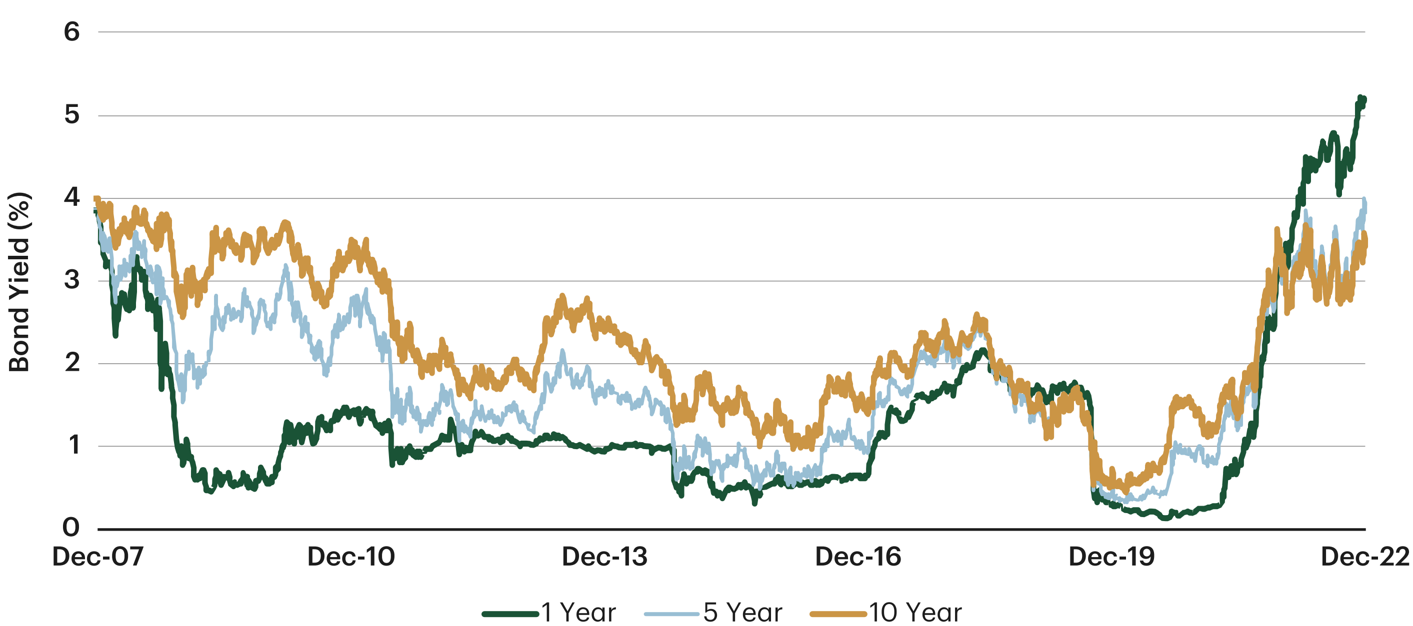


Source: Bloomberg L.P., FTSE Global Debt Capital Markets Inc., TD Asset Management Inc. (TDAM) as at June 30, 2023.

Bonds: Good Opportunity for Positive Returns

A by-product of a growing economy is inflation. To combat inflation, central banks raise interest rates to slow the economy, which helps alleviate inflationary pressures. Inflation in Canada has receded since it peaked at over 8% in June 2022, according to the Bank of Canada, cooling to approximately 3% at the time of this writing, but it has not yet reached the desired 2% target rate. Easing inflation suggests that we are closer to the end of the rise in interest rates and will remain a focus for central banks throughout the year. Until inflation gets back to more comfortable levels, we believe we may see interest rates stay higher for longer. The silver lining is that yields are currently at attractive levels that have not been seen for more than a decade as seen in Chart 2 below.

Chart 2: Government of Canada Bond Yields: 2007 to June 2023



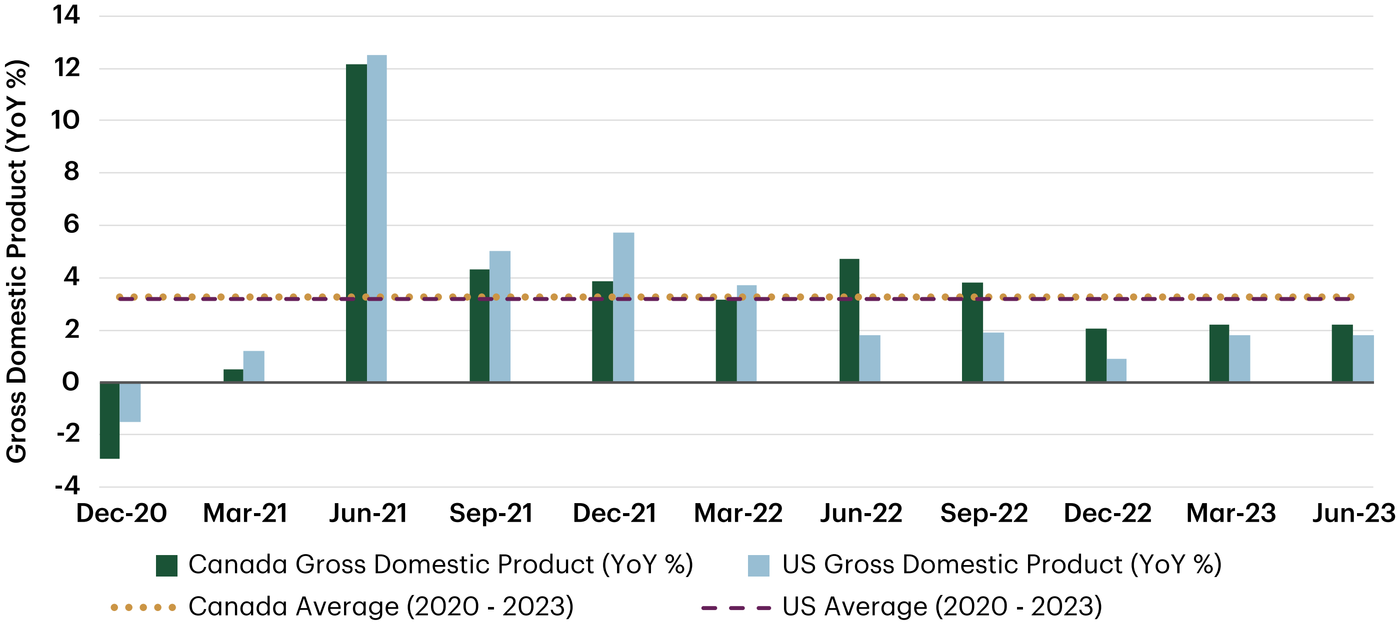
Source: Bloomberg L.P., TD Asset Management Inc. (TDAM) as at July 12, 2023.

Bonds: Diversification in Challenging Times

At the start of 2023, the trajectory of inflation remained the central issue for global financial markets. We expected policy makers to maintain higher interest rates to curb inflation, which would be a key factor in shaping economic dynamics ultimately leading to a curbing of economic growth.

As we assess the current economic landscape, our expectations regarding economic growth have been broadly met. The U.S. economy has experienced a slowdown, as confirmed by the modest 1.8% growth rate in the second quarter of 2023 – well below the average growth rate recorded in recent years. In contrast, the Canadian economy has outperformed other G7 countries, yet growth remains below the average recorded in recent years.

Chart 3: Average Gross Domestic Product Canada and United States between 2020 and 2023



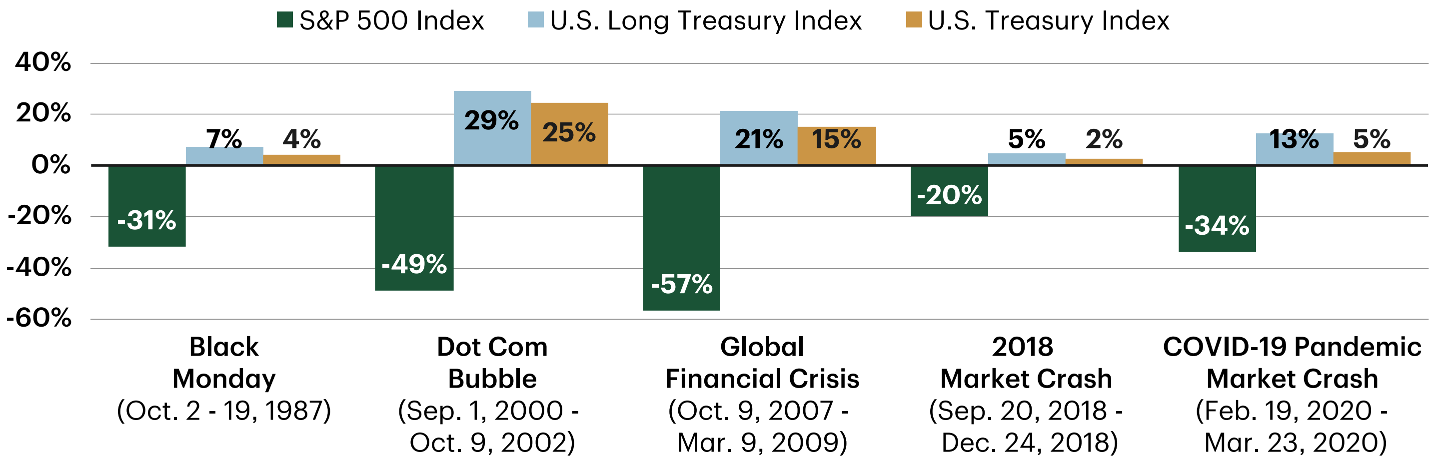
Source: Bloomberg L.P., TD Asset Management Inc. (TDAM) as at June 30, 2023.

We remain mindful of higher interest rates, which present challenges for both consumers and banks. Consumers face higher credit costs, prompting a shift from spending to saving. Simultaneously, banks, reliant on short-term deposits for lending long-term loans, tighten lending standards, impeding business growth and activity. Consequently, economic activity and corporate earnings begin to cool.

This is where we see the second opportunity for bonds. Bonds may be able to act as a “shock absorber” during challenging economic climates. Chart 4 below illustrates returns for stocks and bonds across the last 5 market shocks. Financial shocks may knock the wind out of stocks temporarily, but bonds may still perform well during equity drawdowns.

Growth

Chart 4: Fixed Income Can Outperform in Recessions and Market Crises



Source: Bloomberg L.P., TD Asset Management Inc. (TDAM) as at June 30, 2023..

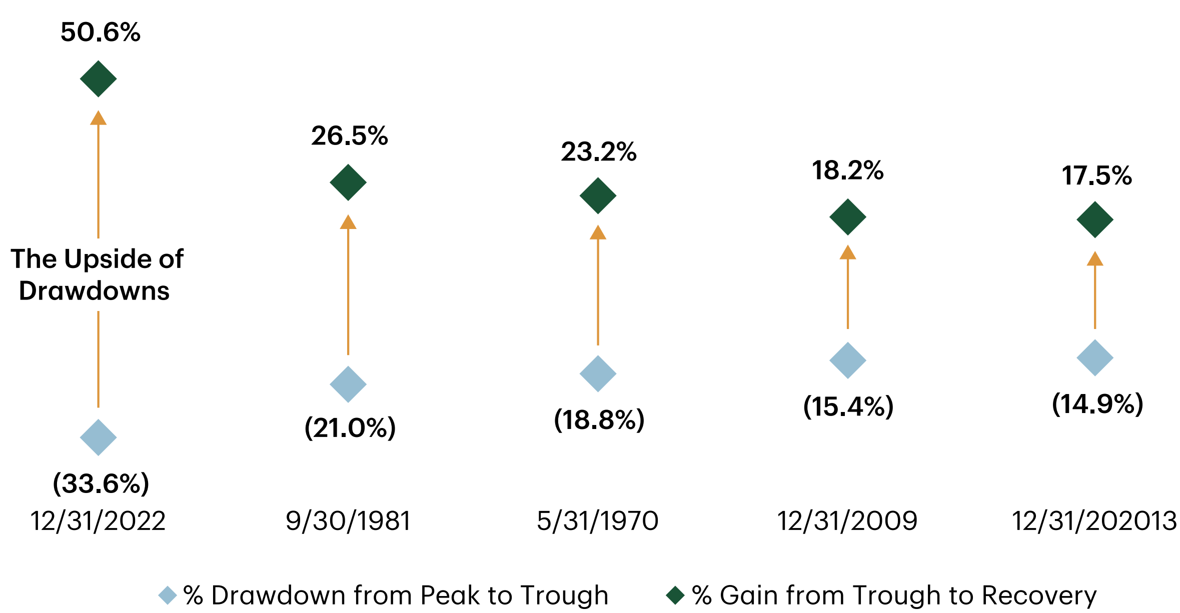
Bonds Through the Ages

Last year's challenges in bonds left many investors disillusioned, and we can see continued hesitation as a potential example of recency bias. Recency bias refers to our tendency to give excessive weight to recent events, particularly extreme occurrences like significant market declines, and project them into the future. This bias can distort investors' perception, making them view potential opportunities as threats. To counteract this bias and broaden our perspective, we can look further into the history of bonds and explore the largest historical declines in bonds and how the market subsequently recovered from them.

The Upside of Drawdowns

Using long-term government bonds, Chart 5 illustrates the 5 worst drawdowns (orange) since 1945 along with the return needed to restore an initial investment after the drawdown(green). For example, in 1981 when bonds declined by 21%, they had to gain 26.5% just to get back to previous levels.

Chart 5: The Upside of Drawdowns



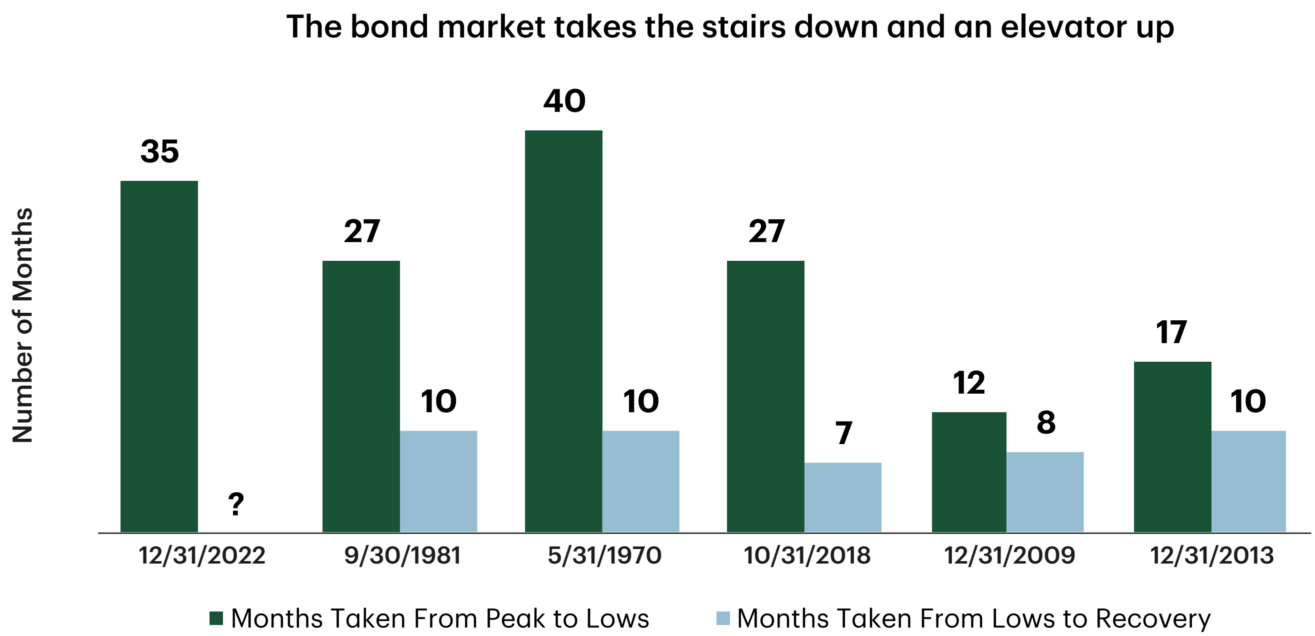
Source: Morningstar® as at June 30, 2023.

This illustration brings up two questions:

(1) were long term government bonds able to achieve the needed return during the market recovery to restore investments, and, if so, (2) exactly how long did that take?

Chart 6 addresses these questions by presenting the time taken from the previous high to the lowest declines (green bars) and the subsequent time required to reach back to the previous high (light blue bars).

Chart 6: Time Taken to Recover from Historical Drawdowns



Source: Morningstar® as at June 30, 2023.

As we can see, the answers to the questions posed previously are (1) yes, long-term bonds have historically recovered to previous levels, and (2) these bonds often experienced gradual declines but rebounded more swiftly. Past performance does not guarantee future results, however, we believe the past can help us gain a broader perspective we might otherwise be missing.

Flexible Thinking: TD Fixed Income Pool

The TD Fixed Income Pool (the "Pool") is an actively managed fixed income strategy that offers an extensive range of diversification across multiple asset classes and investment strategies. Our portfolio construction process has evolved to incorporate more tools to enhance flexibility across our solutions, which we believe will be critical to managing risk during a period of persistent high volatility. Specifically, we have been actively using derivatives such as bond futures and credit default swaps to replicate interest rate risk and credit risk exposures without transacting in the cash bond market. This allows us to diversify sources of liquidity within our portfolios and therefore enable more tactical allocations across markets.

As we look ahead to an environment of tighter financial conditions and higher volatility, we understand that investors may become increasingly concerned with near-term portfolio return outcomes. However, we also expect this to be an environment of more opportunities, in which we believe our actively managed strategies are well positioned to take advantage of market dislocations in order to boost long-term total returns.

Let's Talk

For more information, please contact your investment professional.

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