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Investing Insights

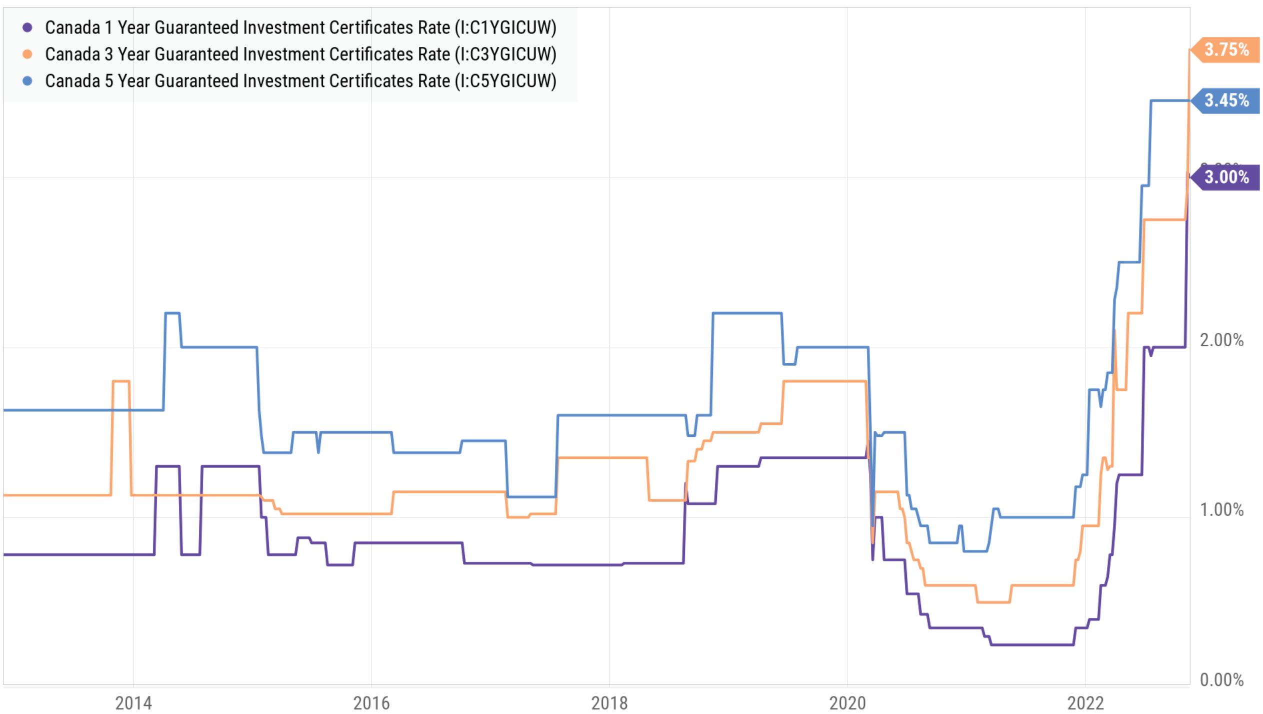
Attention fixed income investors, yields are baaaack!!

For what feels like an eternity, and certainly any time since the global financial crisis of 2008-2009, it has been a very challenging time for fixed income investors to generate much "income" from their fixed income investments. This is particularly the case for those looking for higher quality, lower risk fixed income investments such as investment grade corporate bonds, government bonds, and guaranteed investment certificates (GICs).

High inflation levels are never welcome, but there are silver lining

With the Bank of Canada taking aggressive steps to combat rising inflation (similarly to other central banks around the world), one side benefit to the rising cost of borrowing has been a rise in bond yields and interest rates available for savers and investors (see Chart 1).

Chart 1: GIC Rates At Best Levels In At Least A Decade



Date Range: 11/28/2012 - 11/16/2022

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Source: Bank of Canada

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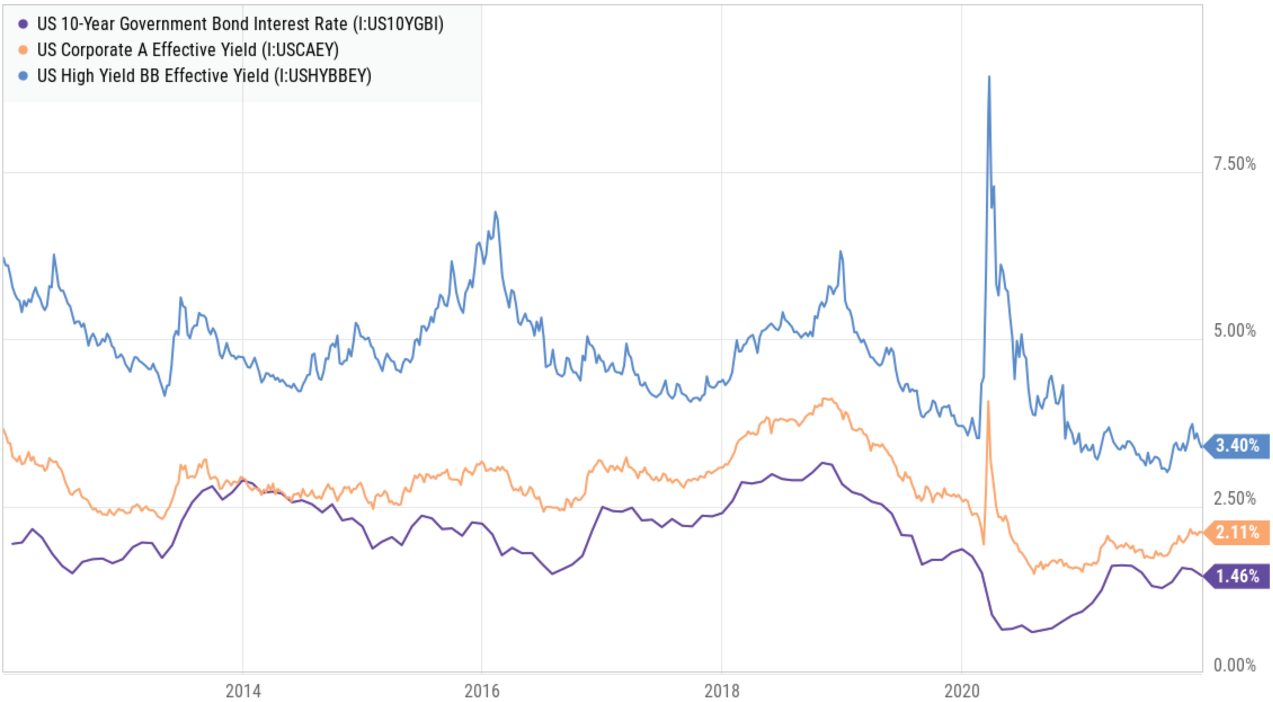
If we look at much of the past decade or so, investors may have climbed higher up the risk ladder in order to find yields within fixed income that were better-than-paltry (see Chart 2). While, taking this extra risk would have contributed to better performance over the past decade, it could just as easily have gone the other way, especially if it weren't for a prolonged low-interest rate environment. There were also some periods of volatility in risk assets, which include high yield bonds, that would have been unnerving for investors not used to seeing volatility in fixed income investments. In other words, some fixed income investors may have taken on more risk than they intended, regardless of the outcome.

Chart 2: Select Bond Yields 2012-2021



Date Range: 01/03/2012 - 12/31/2021

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Sources: Eurostat, Bank of America Merrill Lynch

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With monetary policy having tightened markedly since the spring of 2022, repricing of assets has taken place, with those investments most leveraged to low interest rates having seen more volatility along the way. High quality fixed income investments have also seen yields go up to reflect the new interest rate environment. Therein lies the silver lining; whether it is to reduce portfolio volatility, enhance quality fixed income exposure, or generate reliable income, rising yields have improved the range of quality investment options available.

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An opportunity to capitalize on current market dynamics

For those who have either sought to increase high-yield exposure to fill the income void in their fixed income exposure, or even replaced it with other assets entirely (dividend equities or alternatives), it may be time to reconsider. The current landscape allows such investors to restructure or rebalance their portfolios and consider quality, or investment grade, fixed income exposure. Some of the key factors that may warrant taking a closer look at investment grade fixed income in the current environment include:

1. Yields are well-above average levels seen over the past decade
2. To dampen potential volatility from risk assets such as equities
3. Asset class diversification is at the foundation of portfolio construction regardless of current market dynamics

No strategy is without its risks

As with any investment decision, there are always risks. For instance, if interest rates rise significantly from current levels, bond yields would likely move higher and put downward pressure on bond prices (bond prices move in opposite direction to yields). Additionally, if the economic outlook improves and inflation eases, risk appetite for equities could improve and drive stronger relative outperformance against bonds. A higher exposure to fixed income could mean missing out on additional upside potential you would have had with more equity or other risk assets in your portfolio. There are always trade-offs between risk and returns in portfolio decisions. Ultimately, making decisions based on your specific circumstances, long-term goals and risk tolerance should be the driving force in arriving at those decisions.