Market Perspectives

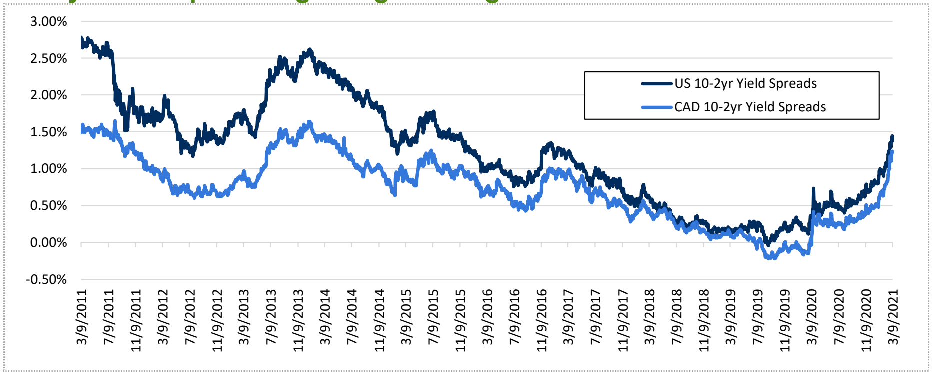
PRIVATE CLIENT SOLUTIONS

Nadeem Kassam, MBA, CFA and Ajay Virk, CFA, CMT March 11, 2021

"No Taper" only Tantrums

Since bottoming in August 2020, US and Canadian 10-year government bond yields have risen sharply by over 100 basis points (bps) as investors have repriced bonds on rising inflation expectations. This is primarily attributed to positive vaccine-driven progress (US vaccination rate is now averaging at ~2 million per day with momentum picking up in Canada), an improving growth outlook, and a commitment by policymakers on both sides of the border to maintain an accommodative posture, including the recent passage of the US$1.9 trillion American Rescue Plan in the US. However, last week, we saw heightened levels of market volatility as investors threw a "tantrum" after Federal Reserve (Fed) Chairman Jerome Powell failed to calm markets following the recent spike in 10-year yields. Sparking the sell-off last week was Chairman Powell's comments at a Wall Street Journal Public forum, where he indicated that while the recent pick-up in yields was "notable", monetary policy would remain "patiently accommodative" until the economy reaches maximum levels of employment. He stated that the Fed's policy would not adjust to "transitory" increases in inflationary pressures when the longer-term inflation outlook remains unchanged. Investors, however, were looking for more calming language, including commentary on how the Fed would prevent or manage a sudden rise in yields. Importantly, US treasuries and Government of Canada bond yields rose with the 10–2 year yield spread (a proxy for the market's expectations for future growth and inflation) rising to its steepest level in five years.

10–2yr Yield Spread Signaling a Rising Growth & Inflation Outlook



Source: FactSet

While we believe yields will continue on an upward trend from here as the economy reopens in H2/2021, we expect this to result in elevated levels of volatility in the years ahead especially as the Fed and Bank of Canada (BoC) begin to unwind stimulus measures. We, therefore, suggest investors: **1)** remain tactical and use these periods of volatility to add to or initiate new equity positions, as history has shown that in periods of rising yields, equities have performed well; **2)** lower fixed income portfolio duration (bonds with higher durations have greater price volatility than bonds with lower durations all else equal) to 5-6 years; and, **3)** take advantage of US dollar strength by reducing some long exposure since we expect the greenback to continue trading defensively as the global economic recovery gains momentum.

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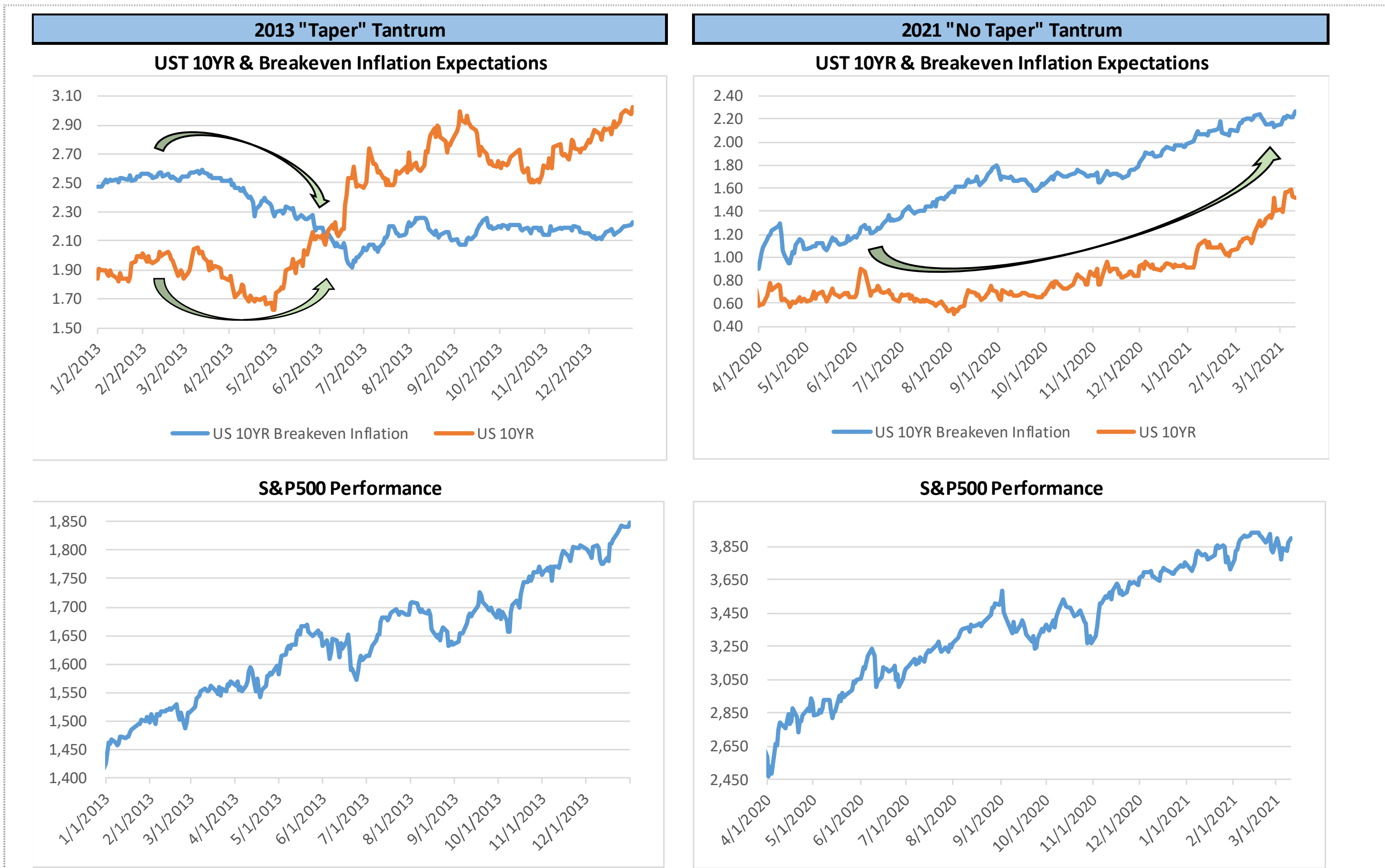
2013 Taper Tantrum vs. 2021 “No Taper” Tantrum

Unlike in 2013, when the markets reacted to then-Federal Reserve Chairman Ben Bernanke announcing that the Fed would, at some future date, reduce the volume of its bond purchases, the recent reaction by investors was to a “no change” in policy stance. Rather, the Fed and the BoC have said that they will maintain accommodative policy until the economy returns to full employment. Again, we would reiterate that the current rise in yields and the subsequent market volatility are occurring for all the “right” reasons – an improving economic backdrop, strong consumer/pent-up demand, and stimulative policy measures which, in our view, are likely to remain in place in some form for several years to come. While we expect yields to stay relatively flat or track slightly higher over the short term, over the long term we are more dovish as an aging population, declining birth rates, and a shrinking workforce will continue to remain a headwind for inflation expectations in North America. Japan and Europe are great examples of the long-term deflation theme in place. Both regions have faced similar demographic headwinds which have led to longer, slower expansions with low rates and disinflationary pressures.

2013 “Taper” Tantrum Led to a Decrease in Inflation Expectations, That’s Not the Case This Time Around!



Source: FactSet

As shown in the above charts, Bernanke’s “taper talk” led to a spike in yields at the long end; however, it also led to a decrease in inflation expectations as the market became concerned that the scaling back of bond purchases would curtail growth and inflation. Fast forward to 2021, investors are now pricing in higher inflation expectations and early Fed tightening due to an improving global economic growth outlook, despite the Fed committing to continue providing monetary support. While the Fed appears unmoved at this point, this may not be the case if yields keep rising and begin to trip the broader market.

Fixed income outlook and positioning

While yields have moved higher rather quickly and are likely to take a short pause, we expect the move from here will be higher as the economic reopening takes shape in H2/2021. Since bond prices have an inverse relationship with interest rates, higher rates mean lower prices and in turn lower returns for investors all else equal. Given our views that yields will continue to move moderately higher, we recommend investors to shorten their portfolio duration (bonds with higher durations have greater price volatility than bonds with lower durations all else equal), to between 5-6 years, on their fixed income holdings. We expect a further back-up in rates will have a negative impact for holders of long-dated bonds. Instead, we recommend investors own bonds with shorter maturity dates or higher coupons (not high yield), which have shorter durations. These bonds should offer better short-term protection against rising rates and reflationary pressures that we expect to occur in the back half of the year. Debt instruments with floating rates (e.g., preferred shares) are another attractive option for income-seeking investors, as are some alternative investments.

Equity outlook and positioning

Our analysis of historical equity market returns during periods of rising rates over the past 20 years reveals that in the majority of these periods, equity returns have been positive. We expect the same will be the case this time around, only more robust thanks to strong pent-up consumer/corporate demand and still very accommodative fiscal and monetary policy. However, the constant tug-of-war between central banks and equity markets will inevitably result in higher levels of volatility especially as central banks scale back stimulus programs in the years ahead. Given this expectation, we believe investors should remain overweight equities versus bonds and maintain well-diversified portfolios of high-quality companies and industries with market pricing power, secular tailwinds, and the ability to grow dividends. This should provide durability to portfolios on the downside when volatility picks up while helping investors capitalize on the growth which lays ahead in this new bull market cycle.

Currency outlook and positioning

As we transition into this global reflationary theme, we will begin to focus more on forward-looking regional growth expectations. This in turn will allow us to move into an environment where we place more weight on macro fundamentals, regional growth divergences, central bank monetary policy normalization, and away from the broader dollar and risk correlation trade (e.g. the correlation between S&P500 and the US Dollar Index has begun to normalize after being negatively correlated for most of 2020). This transition should occur through the lens of a broadly stronger dollar in the short term with emerging market/G10 currencies modestly pulling back. In the second half of the year, global vaccine deployment and lifting of economic restrictions will be the main driver in our view for the global reflation theme. This will naturally be bullish for risky assets including high-beta/commodity currencies like our Canadian dollar, and weigh on the broader US dollar in the process. So while we expect a moderate firming of the US dollar in the short term, the Fed's commitment to let inflation run "hot" while maintaining a slew of stimulative measures (e.g., quantitative easing) will likely weigh on the greenback until the Fed pivots its policy stance.

Next steps

So while markets have rebounded from the sell-off last week, we expect this constant tug-of-war between markets and the Fed/BoC to be an ongoing theme, which we expect will lead to increased market volatility especially as inflation picks up and central banks begin to remove stimulus from the market. And while we believe the current rise in yields is occurring for all the "right" reasons – an improving economic backdrop, strong consumer/pent-up demand, and stimulative policy measures ¬– rising yields have varying degrees of impact on equities, bonds, and currencies and as such we suggest investors position their portfolios accordingly, given our views that yields will continue to push higher.

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