Don’t fear the bond market

And if bonds aren’t expensive, stocks may be cheap

Normalization: a peculiar assumption
As of the beginning of the year, 100 per cent of the 18 forecasters surveyed by Bloomberg expected bond yields in Canada to move higher by mid-year.¹ 100 per cent were wrong.

It’s not just in Canada that forecasters have been wrong-footed. In the U.S. and other developed markets, rising interest rates were considered by many to be a no-brainer. Interest rates are unusually low, went the argument, as the economy recovers and central banks lift their policy rates to more normal levels, bond yields were sure to follow.

This always seemed to be a peculiar assumption to us, partly because the consensus was effectively betting on something that had never actually happened before.

The fact is, in the era of independent monetary authorities, no central bank in a developed market has ever put rates to zero and then had them return to a level that would previously have been considered “normal.”

Many of these 11 central banks, most notably the U.S. Federal Reserve, put rates on the floor during the crisis and have kept them there ever since. The Bank of Japan, of course, got there many years earlier and never really left. Of the central banks that did start the process of normalizing rates after the crisis, including the Bank of Canada, none have managed to do so sustainably (see Exhibit 1).

**EXHIBIT 1: Official interest rates**

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<th>United States</th>
<th>Eurozone</th>
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Source: FMR Co., Haver Analytics and National Central Banks
Now, one could argue that, Japan (and Switzerland) aside, we’re really only talking about a single episode: a post-crisis environment where the sluggish recovery in the U.S. and Europe has forced the U.S. Federal Reserve and European Central Bank to maintain near-zero interest rates, effectively tethering other central banks to the floor. But that argument applied at least as well three or four years ago, and that didn’t prevent the consensus from consistently expecting some normalization of interest rates on the visible horizon. Yet here we still sit.

In our view, it is no coincidence that interest rates have struggled to rise in recent years. Important structural forces have been restraining interest rates, forces that are at least as likely to intensify as to dissipate in the years ahead. As a result, while interest rates will surely rise (and fall) with the business cycle ahead, they can be expected to do so in a range below the one we have become used to over the past 40 years or so. This means that investing in bonds is not the obvious money-losing proposition that many have assumed. And if bonds aren’t in fact expensive, stocks may actually be cheap.

“Lower for longer” interest rates
First, let’s examine some of the structural forces restraining interest rates. Demographics are particularly important here. As is well known, populations are aging across developed countries and will continue to do so in coming decades (this is one of the few forecasts that can be made with great confidence). This tends to weigh on interest rates in two ways.

One, as the number of retirees rises relative to the working-age population, the economy’s potential supply of labour tends to expand more slowly. The lower the growth in this “trend labour input,” the lower the growth rate of the economy’s overall capacity, which tends to be associated with a lower real interest rate over time.

Two, older investors require more conservative portfolios. Demand for bonds can therefore be expected to increase in line with the rising relative size of the older cohorts (See Exhibit 2), tending to push bond valuations up and yields down.

Both of these effects are at work in Canada. Growth in trend labour input has already begun to slow, meaning that real growth in the Canadian economy’s potential – that key anchor for real interest rates – can be expected to keep declining from over 3% at the turn of the millennium to closer to 1% a decade hence. And the general increase over the past several years in the valuations of Canadian bonds relative to both stocks (the equity risk premium) and the expected path of short-term interest rates (the term premium) suggests the aging-related bid for bonds is already having an impact on Canadian financial markets.

Low interest rates may also become self-reinforcing. Low financing costs encourage leverage and erode discipline among households, firms and governments alike. This makes the economy less able to stand any given degree of normalization in interest rates, effectively “trapping” the economy in a stagnant, high debt/low-growth environment.

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EXHIBIT 2: Demographics drive higher demand for bonds

![Exhibit 2: Demographics drive higher demand for bonds](image)

Source: FMR Co., Pyramis Global Advisors and Statistics Canada
rate environment. This is the essential story of Japan over the past two decades, and there are troubling signs that similar dynamics may be emerging closer to home.

These are some of the forces that can be expected to restrain real interest rates for many years to come. What about inflation? The most appropriate forecast remains a benign one – that the Bank of Canada, the U.S. Federal Reserve and others will succeed in hitting their two per cent inflation target in the long run. Recently, inflation in Canada and the U.S. has been edging up from very low levels, but central banks have shown they know how to deal with higher inflation if this trend continues. What they haven’t been able to do reliably is keep inflation up – even after five years of near-zero interest rates, inflation remains lower than the Bank or the Fed would like. This important asymmetry would suggest a balance of risks tilted towards a lower, bond-friendlier path of inflation over time.

Investment implications
This “lower for longer” interest rate phenomenon has been informing our positioning in the Canadian asset allocation funds in two ways.

First, we have maintained substantial allocations to fixed income. Although our exposure to duration risk will continue to evolve along with the outlook, our general inclination is to play defence with bonds rather than cash in this environment, collecting the carry and rolldown return as the consensus waits for a big back-up in rates that may be a long time coming, if in fact it ever does. In addition, the first half of the year has illustrated that bonds still have room to rally, even in this low-yield world. This is particularly true of the U.S. Treasury market, where longer-term rates are higher and the yield curve steeper than in Canada, and where the expected appreciation of the U.S. dollar in a risk-off scenario adds to the appeal of the position in a Canadian portfolio.

Second, if bonds aren’t expensive, then stocks may be cheap. Just because the S&P TSX Composite is trading at around its historical average valuation (roughly 15 times forward earnings) doesn’t mean it’s trading at fair value. If longer-term interest rates have shifted durably lower, then so has the discount rate that should be applied when valuing equities, resulting in a higher sustainable level for the market multiple. In other words, bonds have adjusted to a low-for-long interest rate world far more than stocks have (See Exhibit 3), leaving equities with greater upside going forward than the relatively subdued earnings outlook would imply.

David Wolf is a portfolio manager and member of the Global Asset Allocation (GAA) group at Fidelity Investments. In this role, he works with the portfolio management team that is responsible for managing Canadian multi-asset class strategies. David is one of the portfolio managers responsible for managing Fidelity Canadian Asset Allocation Fund, Fidelity Monthly Income Fund, Fidelity Dividend Fund and Fidelity Income Allocation Fund.

EXHIBIT 3: Getting paid to be in equities

![Graph showing long-term bond yield, Government of Canada vs. forward earnings yield, S&P/TSX Composite](source: FMR Co., Haver Analytics, Factset and Bank of Canada)
For Canadian investors

For Canadian prospects only. Offered in each province of Canada by Fidelity Investments Canada ULC in accordance with applicable securities laws.

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Investing involves risk, including the risk of loss.

1 Source: Bloomberg, January 2014.

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