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Fixed Income Insights

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These Cash Yields May Not Be Here to Stay

Is It Time To Shift From Cash to Bonds?

Author

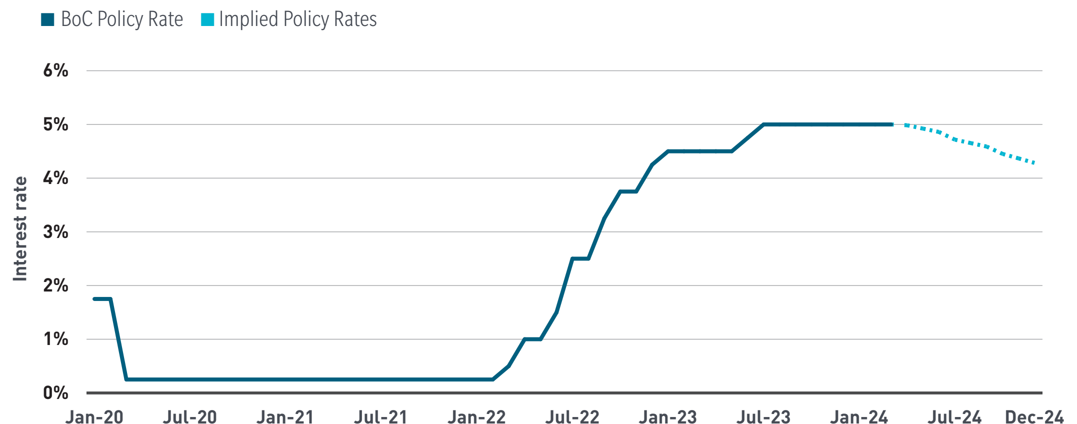
David Peterson
Lead Analyst
Investment Solutions Group

In Brief

- **After two years of rising rates, market expectations are for the Bank of Canada to begin a rate cutting cycle sometime this year**
- **Historically, the end of a rising rate environment has been an inflection point for credit to outperform cash**
- **We would therefore favor deploying more credit risk exposure in the period ahead, while reducing cash allocation**

The past two years have seen the Bank of Canada (BoC) engaged in a swift rate hiking cycle in an effort to tame the highest inflation rate the country has experienced since the 1980's. Today the inflation rate sits at 2.9% and is nearing the Bank's target rate of 2%. Its policy interest rate, the overnight lending rate, stands at 5%, following a 475bp tightening cycle. With inflation having corrected lower, there is now room for policy easing. In exhibit 1 we can see that market participants have currently priced in three separate 0.25% rate cuts up to December 2024.

Exhibit 1: Bank of Canada Policy Rate and Market Implied Rates



Source: Bloomberg, Bank of Canada. Monthly data from 1 January 2020 to 31 March 2024. Data for April to December 2024 based on Canada OIS futures.

The rising rate environment we have just experienced has been painful for Canadian fixed income: from the end of 2021 to the end of 2023 the Canada Universe Bond Index returned -2.9% annualized.[1] With the inverse relationship between yields and bond prices being a major headwind for fixed income, many investors sought protection in cash as a safe haven. Looking at Exhibit 2, historically cash returns have outperformed short-term Canadian corporate bonds when the policy rate is rising. Cash investments do not see their prices decline when yields go up as bonds do, which is why many of the grey outperformance bars occur when market yields are going up.

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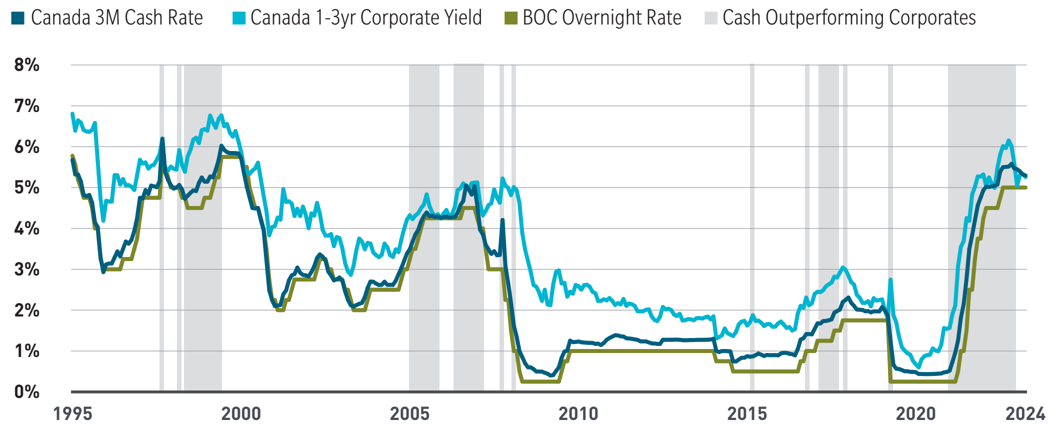
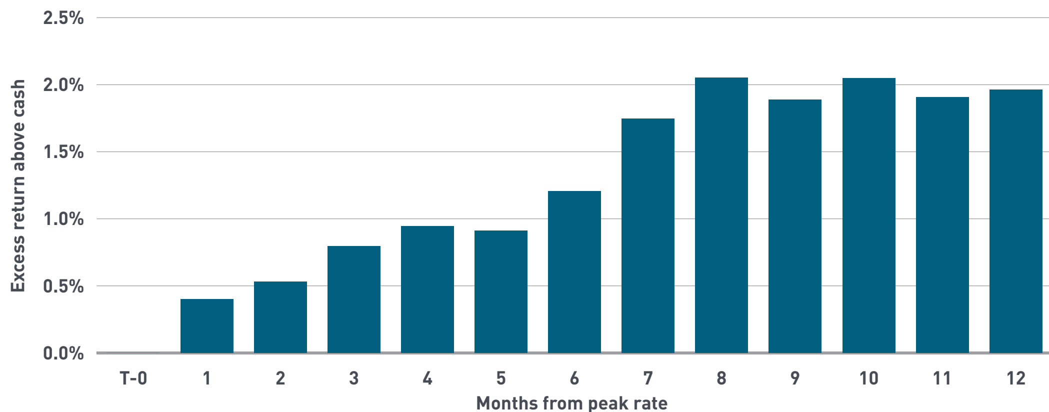
Exhibit 2: Canada Cash versus Short Canada Credit Yields



Source: Bloomberg, ICE BofA, Bank of Canada. Monthly data from 31 January 1995 to 31 March 2024. Grey bars represent periods of cash outperformance above short-term corporate bonds. Cash = ICE BofA Canadian Dollar 3-month offered rate index. Canada 1-3yr Corporate = ICE BofA 1-3yr Canada Corporate Index. Returns are gross and in CAD. Past performance is no guarantee of future results.

Today however we are likely at the Bank of Canada peak rate. Once the rate hiking cycle ends and the cycle transitions to cuts, we have observed historically that cash no longer outperforms credit. The same inverse relationship between prices and yields that harmed bonds during rate rises may now help drive higher returns as the BoC policy interest rate falls. In Exhibit 3 we analyze the past 5 major rate hiking cycles since 1995. The key result is that short-term corporate bonds have historically outperformed cash over the subsequent 12 months from the peak rate by an average of 2%.

Exhibit 3: Canada Short-term Corporate Bond Outperformance Over Cash at Peak Policy Rate



Source: Bloomberg, ICE BofA, Bank of Canada. Monthly data from 31 January 1995 to 31 March 2024. Cash = ICE BofA Canadian Dollar 3-month offered rate index. Canada 1-3yr Corporate = ICE BofA 1-3yr Canada Corporate Index. Returns are gross and in CAD. Past performance is no guarantee of future results.

While we find short tenor corporate bonds attractive as they have historically outperformed cash at the end of a rate hiking cycle, we also favor longer tenor corporate bonds as well. Longer maturity bonds have higher sensitivity to changes in their price for changes in yield. With BoC rate cuts being hinted at for later in 2024, we believe it may be prudent to add additional duration beyond that of just short-tenor corporate bonds to try to capture as much benefit from the rate cutting cycle as possible. The Bloomberg Canada Corporate bond index today has seen much of its yield valuation restored over the course of the rate hiking cycle, seeing yields today just off of their local highs at 4.90%, as of 20 March 2024. Yields today mean you are likely to get a comparable amount of income from yields as you would in cash, but with added potential upside if rate cuts emerge.

Exhibit 4: Canada Corporate Yield-To-Worst

Source: Bloomberg. Monthly data from 31 January 2009 to 31 March 2024. Canada Corporate = Bloomberg Canada Aggregate Corporate Index.

While shifting investor allocations from bonds to cash appeared to be the right move for many during the rate hiking episode, impending rate cuts from the Bank of Canada may indicate it is time to re-allocate back to fixed income. The rates market is anticipating a rate cutting cycle to begin by mid-year, with the first rate cut priced in at the June meeting.[2] With a short window between now and then, investors may want to consider the opportunity to seek exposure to what has been the most attractive level of corporate credit yields since the global financial crisis.

End Notes

[1] Bloomberg, FTSE. Daily data from 31 December 2021 to 29 December 2023.

[2] Bloomberg. June meeting cut based on implied rate from Canada OIS futures prices.

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