CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

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Brexit Overshadowing the Real Story

On June 23, the United Kingdom held a referendum, nicknamed "Brexit", to decide whether it should leave or remain in the European Union. Voters chose to leave by a margin of 52% to 48%. The result surprised many investors who had believed that the probable negative economic impact of leaving would persuade U.K. voters to stay. Stock markets reacted initially with a selloff before rebounding. Bond markets strengthened, driving bond yields lower.

Brexit captured an immense amount of media attention, obscuring the larger underlying economic story, which is the fall of bond yields around the world to record lows. Certainly Brexit contributed to the continuation of this trend, but the trend was already well established. In this second quarter (Q2) edition of our Newsletter, we will discuss where bond yields are today and what record low yields mean for client portfolios.

The Basics of Bond Yields

We will start with the basics. Although this introduction may be too simple for many clients, it may be helpful for others. Think of a bond as a loan that an investor makes to a borrower. When you purchase a bond, you are lending money. All of your common sense about lending money should therefore apply, but in today's bond market, it won't help you much.

When lending money, you would want to know, at a minimum: a) how creditworthy is the borrower? (what are the chances of being repaid in full?); b) what interest rate are you getting?; c) when will the loan be repaid?

If a very creditworthy person asked you for a multi-year loan with no interest, you would politely decline (or perhaps laugh openly at the absurdity of the request). You would have no incentive to make the loan. You would be taking a risk without receiving a return.

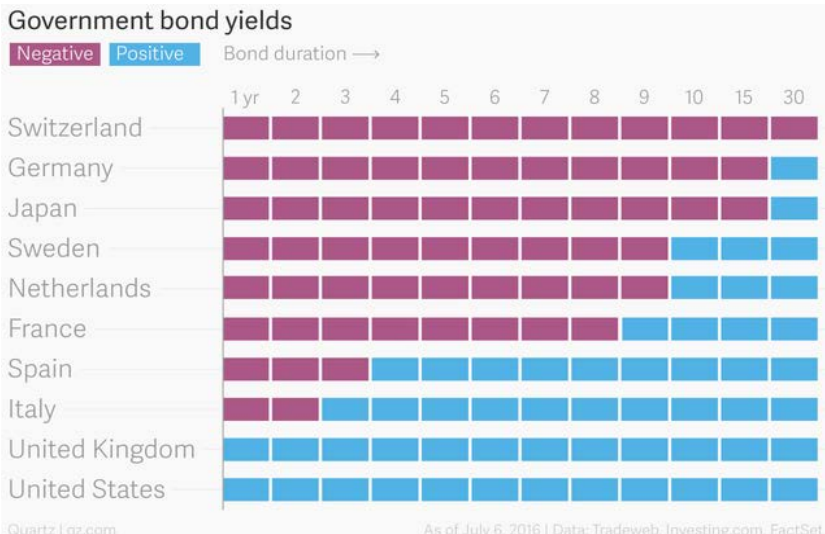
Even if the borrower did repay you in full, the money would be worth less in terms of your purchasing power due to inflation. For example, in Canada, our central bank's mandate is to target 2% inflation, defined as the year-over-year increase in the total consumer price index (CPI).[1]

Keeping those points in mind, consider the current bond market environment.

Bond Yields Today

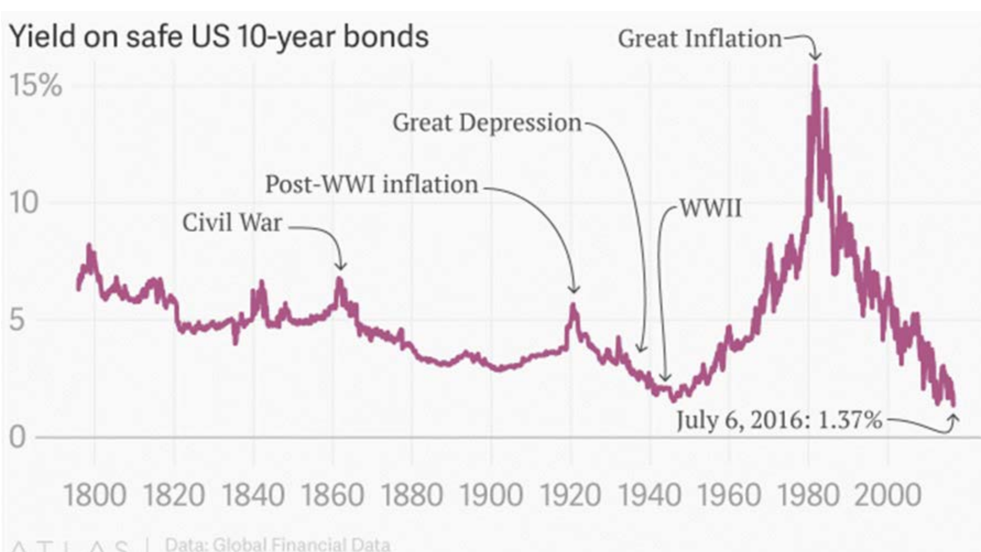
Government bonds dominate the bond category, and the yield investors are receiving from them has never been lower. Government bonds of most developed countries are generally considered low risk assets.

Therefore, it is normal for these bonds to trade with lower interest yields than bonds issued by corporations and other fixed income assets. What is not normal is the record lows to which many government bond yields have fallen. Consider the following chart, which depicts the current developed country government bond market:



It shows that investors are willing to accept negative yields on multi-year government bonds issued by several of the world's most significant countries. For example, an investor who purchases a 10-year bond issued by Switzerland today and holds it until maturity is guaranteed to lose money. If this sounds crazy, that is because it is, or at least it would be considered crazy by an individual investor with common sense. (That said, it may not be crazy for a large institution with a restrictive investment mandate to accept negative yields – we will discuss that briefly later.)

Note the last row of the chart above. The United States still has positive yields across all maturities; however, its government debt is also trading with all-time low yields. The chart below shows over 200 years of data on 10-year U.S. government bond yields: [2]

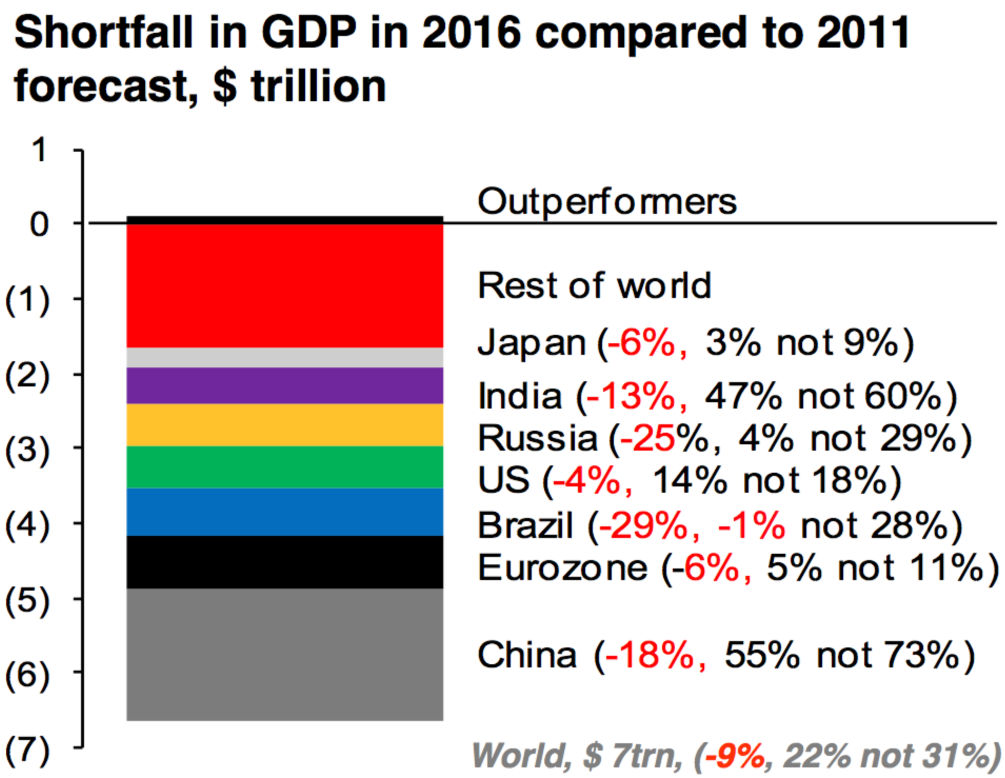


An investor who accepts a yield of 1.37% on a 10-year bond held to maturity may receive a negative real return after considering inflation.

The charts above do not address Canada, but we will mention that the yield on 10-year Canadian government bonds recently closed below 1% for the first time.

Why Yields are So Low

There are lots of theories explaining why rates are so low. In our view, the root cause is the weak economic performance globally over the past decade. Consider the following chart, which depicts the shortfall in 2016 global economic performance relative to prevailing expectations in 2011:[3]



Source: IMF, Macquarie Research, June 2016

The chart indicates that US$7 trillion of global GDP is "missing" relative to projections. To put that in perspective, Canada's entire GDP is under US$2 trillion, and Canada is the 10th largest economy in the world.[4] This underperformance by the world economy has motivated central bank interest rate suppression and bond buying. It also has led to institutional safe haven bond buying due to the perceived risk of alternative assets.

Many large institutions have restrictive investment mandates and so much cash to invest that they will actually accept negative yields on government bonds rather than take the risk of owning other types of assets. (A counter-example is the large German bank Commerzbank, which was reportedly considering hoarding billions of euros in vaults rather than paying a penalty charge for parking it with the European Central Bank.[5])

Consequences of Low Yields

Clearly, over the past five years, those (few) investors aggressively positioned for falling rates have been correct. We have maintained a more diversified approach. Some positions in our model portfolios have benefitted from falling rates and others have suffered. Companies with significant debt have refinanced at lower rates, increasing earnings. Due to falling borrowing costs, our recent purchases of real estate investment trusts, discussed in detail in our Q1 2016 Newsletter, have provided immediate returns that have exceeded expectations. Also, low rates also provide a boost to dividend stocks as their dividends look attractive to investors in comparison to bond yields.

Other positions in our model portfolios have suffered in this yield environment. Our U.S. bank stocks are valued at very attractive levels, but they continue to struggle with low net interest margins (the difference between interest income from loans and the interest paid on deposits). Also, our insurance stocks typically invest a large amount of the premiums they receive in fixed income assets, and low rates hurt their investment returns. We are always assessing client portfolios, and if we begin to believe these headwinds cannot be overcome in a reasonable time frame, we will consider changes to increase returns.

The largest difficulty we have had as a result of low yields is finding adequate returns in fixed income assets. Even five years ago, we were able to access a significant inventory of individual government and corporate bonds with significant yields on behalf of clients. Today, there is far less selection, as pension funds, mutual funds, insurance companies and other institutional investors rapidly take up any high-quality fixed income asset before retail investment advisors have a chance.

In our Balanced Portfolio, we cope with this scarcity of bond inventory by using a blend of exchange-traded funds (ETFs) and actively managed mutual funds, instead of attempting to source enough of an individual bond to divide evenly among clients. This means we are heavily diversified in the fixed income portion of our Balanced Portfolio among various types of Canadian bonds and also among passive and active investment strategies.

Where Yields are Headed

We do not know where yields are headed from here. If we were to position portfolios aggressively for a scenario where yields stay flat or fall for the foreseeable future, we would be risking large losses, and we are not inclined to take that risk. Conversely, we have long believed that yields would eventually normalize from emergency levels by rising somewhat. We now have to acknowledge that this view has been wrong so far, as much time has passed, and it has simply not happened. We are simply not aggressively positioned either way.

The question that investors face today is whether today's low yields are the "new normal". Many are wary of the Japanese experience over the past 20+ years. Over that time frame, Japan has moved in and out of recession and in and out of deflation, despite forceful policy actions from its central bank, suggesting that it is possible for low growth and low yields to stubbornly persist in a large developed economy. Demographics have been a drag on Japanese economic growth, as an aging population tends to spend less and take less entrepreneurial risk.

On the surface, Canada and the U.S. do not appear to share Japan's severe demographic problems. In any case, they permit more immigration than Japan, which is very insular. Some European nations are arguably more comparable to Japan, due to their demographic issues.

Since it is not really part of central banks' mandates to give up and "throw in the towel", some commentators are now predicting globally coordinated central bank action to spur economic growth. The recent strength in precious metals prices reflects the market's anticipation of this action, as the central bank action could be inflationary.

However, central banks have lost a lot of credibility over the past decade. Their main policy tool of interest rate manipulation has failed to reignite economic growth around the world. Also, many economic entities have borrowed large amounts in reliance on low rates, meaning any significant rate increase is now more likely to tip economies into recession. Central banks may well begin new rounds of coordinated action, but if past experience is any guide, it will have more of a short-term positive impact on financial markets and less of a long-term positive impact on real world economic growth.

Q2 Portfolio Highlights

On May 25, we added to our position in Abbott Laboratories (NYSE:ABT) in the Total Return Portfolio at a price of US$38.15. Abbott Laboratories recently made a bid to acquire St. Jude Medical Inc. (NYSE:STJ), a maker of cardiac and vascular products. When the bid was announced, Abbott shares dropped over 10% in a few days, allowing us to add shares for the long term at a lower price. Abbott will be taking on more debt, but is now projected to grow its earnings per share (EPS) at more than 10% per year for 2017, 2018 and 2019.[6] It is rare to find a high quality large capitalization company like Abbott that benefits from the low cyclicality of the healthcare industry, pays a significant dividend of around 2.5% and also offers significant EPS growth potential.

On April 13, we purchased a new position in Brookfield Renewable Partners L.P. (TSX:BEP.UN) in both the Total Return Portfolio and the High Yield Portfolio at a price of $37.27 per unit. Brookfield Renewable operates a large portfolio of hydroelectric and wind power generation facilities in North America, Latin America and Europe. On the same day, we also purchased a new position in Brookfield Infrastructure Partners L.P. (TSX:BIP.UN) in those portfolios at a price of $53.06 per unit. Brookfield Infrastructure operates high-quality infrastructure assets such as electrical transmission lines, seaports, toll roads and communications towers. Both Brookfield Renewable and Brookfield infrastructure offer steady cash flows with some moderate growth potential and pay substantial distributions of 4-5% per year.

On April 13, we purchased a new position in Canadian National Railway Co. (TSX:CNR) in the Total Return Portfolio at a price of $81.52 per share. The company operates Canada's largest railroad system, which spans the entire country, and extends down to the Gulf of Mexico through the U.S. Midwest. Canadian National has demonstrated exceptional financial performance for more than a decade, including strong revenue and earnings growth, high profit margins, consistent dividend increases and share buybacks.

As usual, we are buying high-quality companies with good track records that tend to pay significant dividends. These types of investments are what clients expect from us, and we will continue to execute our strategies.

Conclusion

We believe that our three discretionary portfolios (Total Return, High Yield and Balanced) are well-positioned for the remainder of the year. While there may not be significant changes coming to client portfolios in the next six months, we are always watching for opportunities to generate higher long-term returns.

Thank you for reading our Q2 Newsletter. We look forward to communicating with you and answering any questions you may have about our discretionary model portfolios, your personal circumstances, or other topics of interest. As always, we thank you for your business.

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APPENDIX "A"

DISCRETIONARY MODEL PORFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

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[1] http://www.bankofcanada.ca/core-functions/monetary-policy/inflation/
[2] http://qz.com/725992/us-bond-yields-have-never-been-this-low-and-we-looked-at-data-going-back-to-1786/
[3] http://www.businessinsider.com/world-economys-depressing-reality-in-one-chart-2016-6
[4] http://money.cnn.com/news/economy/world_economies_gdp/
[5] http://www.reuters.com/article/us-commerzbank-ecb-idUSKCN0YU1HW
[6] JP Morgan, Abbott Laboratories Report dated May 11, 2016.

David Papau, Michael Armstrong and Andrey Schmidt are Investment Advisors with CIBC Wood Gundy in Vancouver. They and their clients may own securities mentioned in this column. Their views do not necessarily reflect those of CIBC World Markets Inc.

If you are currently a CIBC Wood Gundy client, please contact your Investment Advisor.