A Perfect Storm for Bonds,
But All Storms Come to An End

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As we noted in May, a sea of red ink is flooding across most asset classes in 2022. Investors can understand that a war in Europe, plus China's ongoing struggles with COVID-19, might bring weakness to equity markets. And, based on historical performance, many likely expected that fixed income would provide ballast when stocks fared poorly. Painfully, this has not been the case to date this year. Instead, markets have encountered a perfect storm.

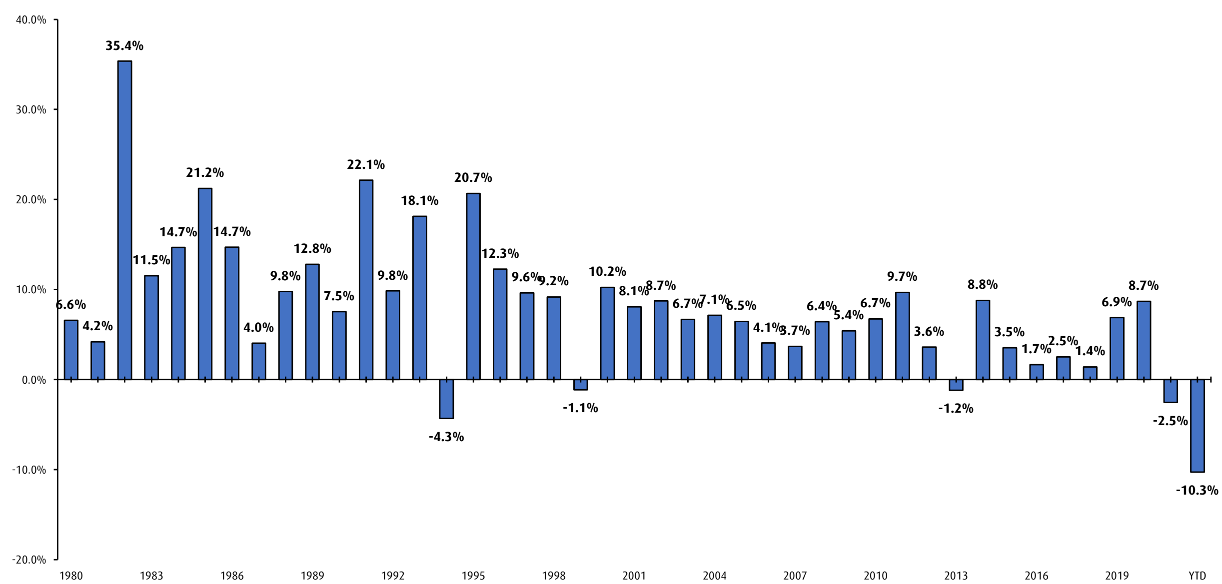
Figure 1 illustrates the historic 2022 plunge in fixed income. The chart also shows how fixed income has generally contributed to portfolio performance over the years while also acting as a risk-mitigation tool.

It is important to note that 2019 and 2020 saw outsized gains from fixed income of 6.9% and 8.7%, respectively, for the FTSE Canada Universe Bond Index. The cumulative return for the last three calendar years (2019, 2020 and 2021) was 13.2%, or 4.2% annualized. However, the challenging environment to open the year, coupled with the current media hysteria over inflation, has investors worried and questioning the value of fixed income in a portfolio.

Figure 1: A Historic, But Rare Drubbing for Bonds

FTSE Canada Universe Bond Annual Total Return

Since 1980 - Includes YTD as of May 2022



Source: Morningstar, May 31, 2022

In this report, we will cover the following:

- What has happened, plus some background on fundamentals in the fixed income market;
- Our fixed income positioning today;
- Why holding fixed income is still a prudent strategy;
- Our outlook for fixed income; and
- A primer on the fixed income building blocks within the BMO Private Portfolios.

What has happened

Bond yields across the maturity spectrum (short-term interest rates to longer-term bond yields) have risen (rising bond yields equate to falling prices for fixed income investments, except for cash). Looking at various factors that impact bond yields is the best way to explain what whipped up this year's perfect storm.

Three primary factors are responsible for the increase in nominal bond yields:

- **Real yield** – is the compensation (net of inflation) for lending out your money.
- **Inflation premium** – is the compensation required to offset the impact of inflation until the borrower pays you back.
- **Risk premium** – is the compensation for lending money to less credit-worthy parties (often referred to as credit spread). Government bonds are defined as "risk-free," and all other bonds are priced with a "credit spread" added to government bond yields of comparable maturity.

Each of these subcomponents has risen in 2022, contributing to the year's historic and miserable start for fixed income. In the first three months of the year, government bonds posted their worst quarterly performance on record.

Throughout the paper, we have included **silver lining sections** that highlight why holding fixed income is still a prudent strategy. In a nutshell, the income generated by fixed income is now much improved. As such, fixed income's role as a contributor to both portfolio performance and diversification is better positioned today than before these necessary adjustments that are working their way through the financial system.

Real yields ultimately reflect the economy's health and economic growth potential. Real yields plunged in the aftermath of the 2009 great financial crisis. After falling into negative territory by 2012, they recovered to positive territory for a few years between 2013 and the pandemic's onset in 2020. During the height of the pandemic, real yields collapsed to historic depths. U.S. 10-year real yields hovered around -1%. Similar securities in Canada flip-flopped between positive and negative 50 bps through 2013 to 2019, then nosedived to the -70 bps range. Year to date, Canadian 10-year real yields have climbed 123 bps to 0.69% as of May 31, 2022.

There is a relationship between the extraordinary policy that central banks have adopted and real yields. During periods of crisis (the financial crisis and the pandemic), central banks expanded their balance sheets through quantitative easing (QE), which means they purchased bonds in the marketplace. This stimulates the economy through easier financial conditions as real yields decline. According to economic theory, QE should be inflationary. Yet, for the decade between 2009 and 2019, it wasn't. Now economic theory is playing out in real-time as inflation has been on the rise since 2021 and now sits at multi-decade highs. In an effort to insulate the economy from pandemic uncertainties, central banks drove borrowing costs down to unprecedented low levels while governments pushed cash out to the economy in additional stimulus. The stimulus now appears to have been too large and lasted for too long, contributing to the current inflation problem. This is only one part of the story; other factors such as supply-chain logjams, commodity shocks and pent-up consumer demand are also stoking inflation.

Central banks are now unwinding these extraordinary stimulus policies, sending real yields higher. This adjustment is painful, with the pain increasing in lockstep with the speed and magnitude of each adjustment. However, in the grand scheme, negative real yields are undesirable. Negative real yields reflect a poor economic backdrop and a lack of investment; they also punish savers. Negative real yields force capital (in the hands of savers) to grasp for a life-ring. In this case, the life ring is ever-riskier returns that investors accept simply to get into positive return territory. Thus far, the adjustment to positive real yields has been rapid, and the hit to fixed income portfolios severe.

The silver lining
Positive real yields are desirable for fixed income investors. A return to positive real yields is a welcome event. It suggests the economy is functioning better and no longer needs the life support that central banks provide. Positive real yields also reward savers; it puts real "income" back on the table for fixed income investors. The income flowing from fixed income portfolios is rising. Cash flowing into fixed income portfolios from bond coupon payments and maturing securities is being reinvested at more attractive rates.

Inflation premium – Nominal bond investors shoulder inflation risk at every turn. Inflation is the fixed income investor's kryptonite. When a fixed income security is purchased, an implicit forecast for inflation is inherent in the yield. If that forecast turns out to be incorrect, the market price of the fixed income instrument must adjust to reflect reality.

There is nothing inherently different with the bond itself, but its fair market value must reflect what it can be sold for at any given moment. Investors armed with this new information are unwilling to purchase that security at the previous price when inflation expectations were lower and more predictable. Inflation is currently running hot and central banks are reacting forcefully to put out the inflation fires. They are removing the QE (hence the real yield reaction noted above) and raising short-term policy interest rates. These changes necessitate a repricing higher for bond yields (and hence lower bond prices) across the maturity spectrum.

The silver lining
Bond markets have incorporated these expected policy moves, sending bond yields sharply higher and bond prices sharply lower. A great deal of recalibration has been done. It will be necessary to see a turn in the path for inflation to keep yields contained at current levels. Some parts of the inflation picture are moderating, while others are still hot. High prices are part of the cure for inflation. As prices increase, demand will weaken as consumers forgo or make substitution choices. The steps central bankers are taking will slow the economy, and this too will dampen demand that should translate into a curb on inflation. There are reasons to believe that a peak for inflation is near. If this proves accurate, the hysteria around inflation in the media, political circles, and the bond market should also peak. This doesn't mean inflation will go away, but the rate of change will moderate, bringing welcome relief from the current hyper-sensitive narrative. The good news is the adjustment in bond yields we've had so far in 2022 has gone a long way toward pricing in these developments.

Risk premium – Bonds with credit spread are a significant part of the bond market. In Canada, provincial, municipal, and corporate bonds feature credit spread. We refer to this space generically as "credit." Similar to the inverse relationship between bond yields and bond prices, corporate bond prices decrease when credit spreads widen (move higher), and corporate bond prices rise when spreads narrow or tighten (move lower). Credit has often provided a respite within fixed income during periods of rising interest rates. Frequently, bond yields rise because the economic outlook improves. Real yields move higher to reflect this, along with a modest and often welcome uptick in inflation. (Note that if inflation is a lender's nightmare, it is a borrower's dream because the loan is repaid in "cheaper" dollars.)

As the economic environment improves, so do the fortunes of corporations. For corporate borrowers, a healthier business lowers the repayment risk to lenders. Credit spreads fall to reflect this lower credit risk. Thus, there are two opposing forces: upward pressure on prices due to narrowing credit spreads and downward pressure on prices due to the overall rising bond yield environment. When inflation was low, the net effect often resulted in corporate bond prices rising. This positive result from the credit segment of fixed income helped offset falling government bond prices.

In the post-financial crisis era, when bond yields rose there was often a welcome offset from contracting credit spreads. The recent past also featured this movement, but the timing and impact are different this time.

Unlike what happened during the financial crisis, the pandemic didn't see credit spreads widen to anywhere near the extent expected, given the damage the economy suffered. Lessons learned during the financial crisis prompted central banks and governments to step into the bond market as early as March 2020. They took extraordinary measures to keep the health crisis from morphing into a credit crisis. The government then took additional measures to insulate households and businesses from the pandemic's impact on the economy (i.e., transfer payments, rent moratoriums, interest relief, and so on).

To the extent that credit spreads did widen in 2020, they quickly recovered – mirroring what happened in equity markets – armed with the belief that governments were a credible backstop to the asset class. After vaccines rolled out, credit spreads narrowed even more, augmenting fixed income returns (witness the 8.7% return in 2020 in Figure 1). At this juncture, there was little attraction to government bonds. Recall that there were negative yields in certain parts of the world and ultra-low yields everywhere else. Investors poured money into the credit space, searching for yield enhancement. The outcome was very tight credit spreads and no room for spreads to narrow in the current rising yield environment.

Lastly, the opening months of 2022 brought widening pressure to credit spreads for many of the same reasons we are witnessing weakness in equity markets. Inflation, ongoing supply-chain bottlenecks, reshoring, de-globalization, and a war in Europe can all be expected to drive up business costs, which eats into corporate profit margins. Additionally, the risk of a recession has increased; credit spreads will need to widen further if the economy does slip into recession. This is not our base case, but the risk has gone up. Any of these developments mean corporations are a greater credit risk than if these problems didn't exist. In summary, the convenience of having credit cushion the blow of a rising yield environment has been absent thus far in 2022.

The silver lining
Credit spreads that have widened offer investors three scenarios, with two out of three being positive outcomes.

- **Positive**: There is the prospect of collecting the now higher income flowing from credit due to the wider spreads available. The yield pick-up on high-quality AAA/AA, A and BBB corporate bonds has increased.

Canada Universe Bond Yield by Credit Rating

Rating	October 2021	May 2022
AAA/AA	1.60%	3.67%
A	2.48%	4.31%
BBB	2.87%	4.74%

Source: FTSE Russell

- **Positive**: There is now room for spreads to narrow should the economic outlook turn out to be better than markets currently have priced. As with equities, a soft landing for the economy would be welcome news for investors.
- **Negative**: Should the economy slow precipitously, further spread-widening and poor returns from credit are to be expected. Additionally, it's unclear how fiscal and monetary authorities might respond this time around to a dislocation in credit markets. After successive interventions to rescue the corporate bond market, governments and central banks have fostered a level of complacency epitomized by the familiar mantra "too big to fail." There is merit in failure of businesses that are poorly run. It frees up resources to flow to healthy companies. Fostering moral hazard[1] in the financial system and artificially enabling companies to survive or pursue inefficient projects needs to be curbed. Central banks and governments may feel the need to try to remove some of the moral hazard they have injected into the financial system. This could result in a rude awakening for some parts of the market.

Our fixed income positioning

In general, the fixed income portion of our portfolios is structurally designed to favour yield enhancement, diversification, and lower sensitivity to interest rate movements (shorter duration). Additionally, we have been favouring shorter duration on a tactical basis. These qualities have served us well during this year's challenging environment (see Figure 2).

Our portfolios feature a combination of traditional fixed income investments (core fixed income) supplemented with alpha-generating satellite strategies (satellite building blocks). Our satellite building blocks provide access to specialty fixed income strategies such as structured notes built exclusively for BMO Private Investment Counsel, Preferred Shares, High Yield Bonds and Alternative Fixed Income exposures. See Figure 2 for further details on our fixed income strategies. These unique approaches to fixed income are consistent with our mission to provide our high and ultra-high net worth clients with a bespoke approach to fixed income.

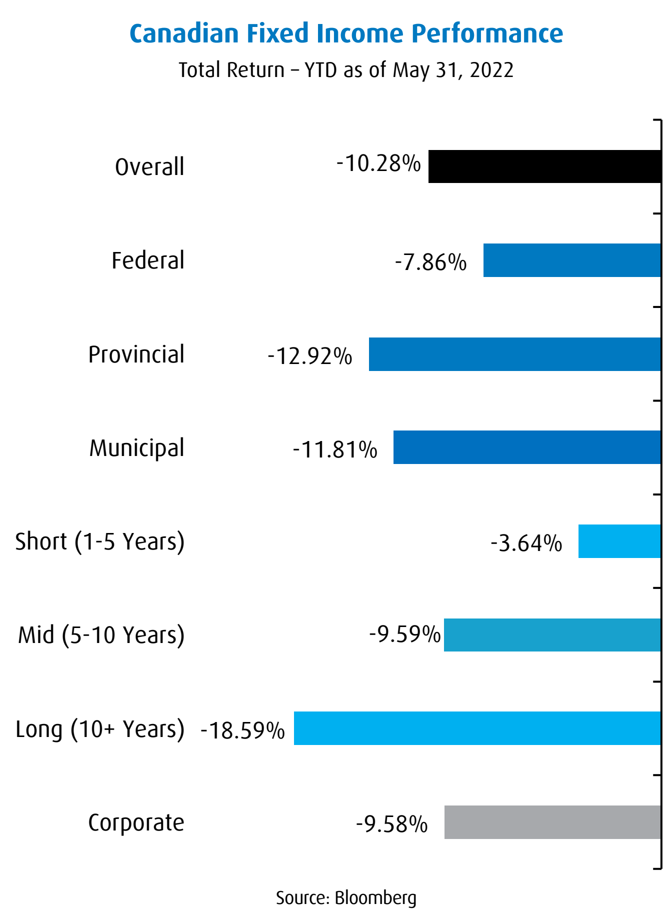
The portfolio is not designed, nor should it be designed, to behave so materially differently from the broad asset class of fixed income that outcomes inconsistent with the general fixed income market come into play. The shock to fixed income over the last several months has been historic. These types of market moves provide little opportunity for respite (see Figure 3). We are confident that our portfolios are doing what they are designed to do.

Figure 2: A broader look at performance

	Calendar Year				
	2022 YTD April 30	2019 - 2021	2021	2020	2019
	Return (Cumulative %)	Return (Annualized %)	Return (Cumulative %)	Return (Cumulative %)	Return (Cumulative %)
BMO Private Investment Counsel Fixed Income Strategy	-6.60	3.98	-0.03	6.69	5.41
FTSE Canada Universe Bond Index	-10.22	4.22	-2.54	8.68	6.87
Canadian Short-/Medium-Term Bond 50-50 Custom Index	-6.77	3.35	-1.80	7.67	4.42

Source: Morningstar, April 30, 2022

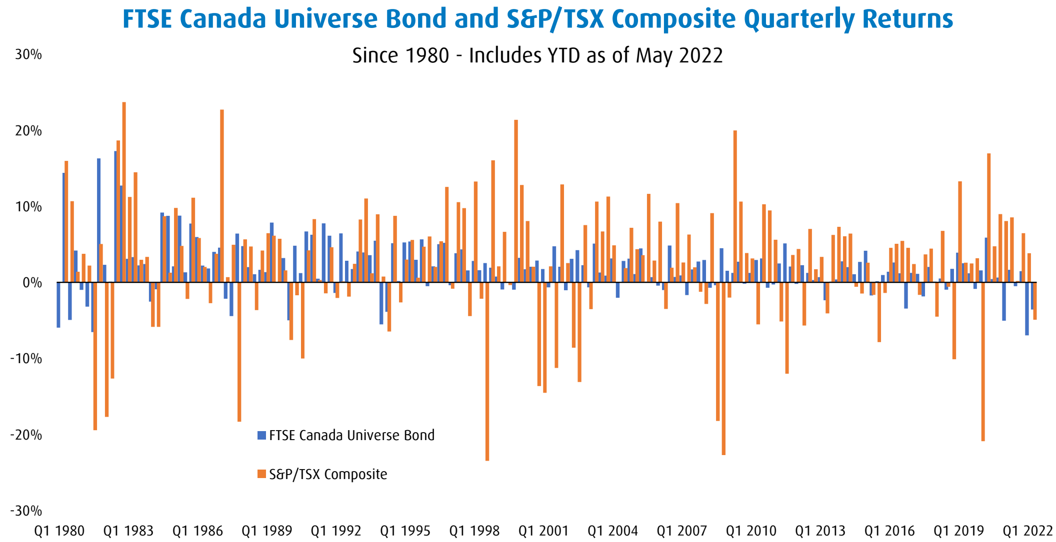
Figure 3: Nowhere to Hide



Why holding fixed income remains a prudent strategy

The case for holding any asset is either that it provides return or reduces risk. In the case of fixed income, it is tasked with doing both. Fixed income does a reasonable job of satisfying this dual mandate, but it isn't perfect. Figure 4 illustrates total returns by quarter of the S&P/TSX Composite Index and the FTSE Canada Universe Bond Index.

Figure 4: Quarterly Returns of Canadian Stocks and Bonds



Source: FTSE Russell, Bloomberg, May 31, 2022

Since 1980 (169 quarters) the breakdown of returns has been favourable:

- 77% of the time, bonds delivered a positive quarterly return;
- 70% of the time, stocks delivered a positive quarterly return;
- 56% of the time, bonds and stocks delivered positive returns in tandem; and
- 8% of the time, bonds and stocks posted quarterly declines in tandem.

Figure 4 also shows the volatility profiles of the two asset classes. The orange bars (stocks) have a much wider range than the blue bars (bonds).

The self-healing power of bonds

In looking at seven instances of consecutive quarterly declines for fixed income over 40+ years, a substantial rebound followed each of these declines:

Q1 1981	**-0.98%**
Q2 1981	**-3.18%**
Q3 1981	**-6.55%**
Q4 1981	**16.30%**

Q1 1984	**-2.54%**
Q2 1984	**-0.91%**
Q3 1984	**9.18%**
Q4 1984	**8.75%**

Q2 1987	**-2.15%**
Q3 1987	**-4.44%**
Q4 1987	**6.42%**
Q1 1988	**4.77%**

Q1 1994	**-5.52%**
Q2 1994	**-3.88%**
Q3 1994	**5.16%**
Q4 1994	**0.19%**
Q1 1995	**5.26%**
Q2 1995	**5.38%**

Q1 2006	**-0.43%**
Q2 2006	**-1.02%**
Q3 2006	**4.85%**
Q4 2006	**0.70%**

Q2 2008	**-0.72%**
Q3 2008	**-0.37%**
Q4 2008	**4.50%**
Q1 2009	**1.52%**

Q4 2010	**-0.71%**
Q1 2011	**-0.27%**
Q2 2011	**2.48%**
Q3 2011	**5.12%**

Source: FTSE Russell, May 31, 2022

Two other key takeaways: the rarity of consecutive quarterly declines for fixed income (seven instances in 40+ years); and the bounce-back return that immediately followed consecutive quarterly declines.

Lastly, fixed income does an excellent job of protecting portfolios when equity markets and the economy are weak. Fixed income is performing poorly today in part because the economy is *not* in recession. If the economy takes a nosedive (not our base case scenario, but the odds have increased), demand would evaporate and inflation would quickly cool. Central banks would reverse course, stop raising interest rates and likely begin to talk about lowering them again. In this scenario, bond yields would be expected to fall, generating positive returns for bonds.

Figure 5: The Safety Trade in Fixed Income

Drawdowns

The following details select S&P/TSX drawdowns and concurrent Canadian fixed income performance:

Peak Date	Bottom Date	S&P/TSX Total Return	FTSE Canada Universe Bond Total Return	Outperformance of Bonds Over Stocks
February 20, 2020	March 23, 2020	-37.2%	-1.6%	35.6%
July 12, 2018	October 29, 2018	-10.4%	-1.0%	9.4%
April 15, 2015	January 20, 2016	-21.5%	0.1%	21.6%
September 3, 2014	December 15, 2014	-11.7%	2.4%	14.1%
February 28, 2012	May 18, 2012	-10.9%	0.9%	11.8%
April 5, 2011	October 4, 2011	-20.6%	8.3%	28.9%
June 18, 2008	March 9, 2009	-48.5%	6.0%	54.5%
August 31, 2000	September 30, 2002	-23.5%	9.3%	32.8%
April 30, 1998	September 30, 1998	-26.2%	4.2%	30.4%
January 31, 1994	June 30, 1994	-10.6%	-9.2%	1.5%

Source: Morningstar, Bloomberg

Even though fixed income assets have weathered a challenging period, the weight of historical evidence gives us confidence that fixed income assets were bruised – not broken. In a storm, a ship trims its sails. The bond market has just been through a harrowing period, but adjusting to a higher yield environment has put fixed income on a different and much-improved footing going forward.

The extraordinary measures taken during the pandemic created untenable imbalances, some of which have been worked off. Fixed income is now better positioned to deliver on the dual mandate of providing both a return contribution and risk mitigation. The yields inside fixed income portfolios are now higher and the ability of fixed income to provide downside protection has improved. Therefore, we can confidently continue to recommend fixed income as a critical tool in portfolio construction and asset allocation for a broad array of our clients.

Outlook for fixed income

We feel the necessary adjustment in bond yields is much closer to the end than the beginning. Fixed income's defensive qualities are not dead — they have just taken a time-out this year. While the adjustment in fixed income YTD has been painful, fixed income positions are more attractive now than they were three or six months ago. If financial conditions become too tight and sink the world into recession, bond yields will fall and inflation talk will quickly fade. We could face a brief period of stagflation. We might actually be in it now, but we don't see that as a chronic condition.

Rising rates and widening credit spreads have made the yields of most fixed income sectors more attractive. Many corporate bond yields are at their highest levels since the financial crisis.

While inflation and bond yields may not have peaked yet, we believe investors are better positioned today to mitigate that risk. Central banks will continue to ratchet up short-term policy rates. There is much less reason for alarm now that bond markets have moved a good distance toward pricing in rate hikes. This is an important point: six months ago, the bond market underestimated the extent of the current inflation pressure and the resolve of central banks to fight inflation. Today, these views have right-sized – and, in fact, may have swung too far the other way.

In the near term, it's probably too early to significantly increase fixed income allocations. But, it is definitely not the time to reduce or liquidate holdings, either. The perfect storm will eventually pass, as all storms do.

BMO Private Portfolios fixed income building blocks

Our benchmark for fixed income is a 50/50 blend of the FTSE Canada Short-Term Overall Bond Index and the FTSE Canada Mid-Term Overall Bond Index. We strive to reduce absolute volatility from the fixed income portion of portfolios. The BMO Private Short-Mid Bond Portfolio has a duration that is three years shorter than the FTSE Canada Universe Bond Index, which currently has a duration of 7.5 years. The BMO Private Portfolio features a current yield-to-maturity (as of April 29, 2022) of 3.32% versus 3.49% for the Universe and 3.35% for the blended 50/50 short-mid benchmark.

Building blocks:

BMO Private Canadian Short-Mid Bond Portfolio:

- Multi-sleeved, dual Short- and Mid-Term passively managed sleeves, managed by BMO Global Asset Management (BMO GAM)
- BMO Private Investment Counsel has the flexibility to adjust the weightings between the sleeves
- Currently, overweight the Short-Term sleeve to reduce duration risk

BMO Private Canadian Corporate Bond Portfolio:

- Passively managed by BMO GAM against a 50/50 blend of the FTSE Canada Short-Term Corporate Bond Index and the FTSE Canada Mid-Term Corporate Bond Index
- Gain credit spread exposure without increasing duration risk meaningfully

BMO Private Preferred Share Fund:

- Actively managed preferred share fund by BMO GAM's Fundamental Equity team for use in several Income Solutions
- Provides credit-spread-like exposure with higher yields than traditional fixed income
- The yield is 4.80% (as of April 29, 2022)

BMO Private U.S. High Yield Bond Fund:

- U.S. high-yield bond strategy actively managed by Columbia Threadneedle Investments (Chicago, U.S.A.)
- Focused on higher quality issuers (single B or better) while providing an attractive yield and rich corporate spread exposure
- The duration of this strategy is 4.1 years, and the yield-to-maturity is 6.47% (as of April 29, 2022)

BMO Premium Yield Note:

- Structured note providing a fixed yield and downside protection barrier with the Solactive Canadian Large-Cap 60 AR Index as the underlying reference index
- The structured note provides a fixed yield and downside protection barrier that emulates corporate bond spread exposure on large cap Canadian companies
- The effective duration is ~3.5 years, and the yield is currently 3.63% (as of April 29, 2022)

BMO Private Global Absolute Return Fund:

- Alternative global fixed-income strategy actively managed by Columbia Threadneedle Investments (London, U.K.)
- Aims to provide stable positive returns through strategic and tactical bond selections, active currency management, and risk management
- The effective duration of this strategy is 1.9 years, and the yield is currently 3.39% (as of April 29, 2022)

Please contact your Investment Counsellor if you would like to discuss your investment portfolio.

BMO Private Wealth

[1] Moral Hazard: A situation where a third-party (government or society) explicitly or implicitly assumes risk allowing the primary party in a relationship not to have to suffer the full potential consequences of their risky behaviour, e.g., the companies and the financial system, in general, assume more risk than they otherwise would. Given successive rescues, they now believe the government will forever bail them out under the auspices of too big to fail.

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